STUDY NOTES

SPECIALIZATION
MODULE-VI

Advanced Auditing and Assurance

ICPAP

Institute of Certified Public Accountants of Pakistan

Question:-

a) **"Management audit requires an inter-disciplinary approach." Discuss outlining the steps involved, management functions appraised and the techniques adopted while conducting management audit.**
b) **"Financial audit and operational audit are not mutually exclusive and are interconnected." Discuss and differentiate between the two.**
c) **State the role of an operational auditor in assessing business controls.**

Answer:

a) Management audit requires an inter-disciplinary approach since it involves a review of all aspects of the management function. It is a comprehensive and constructive examination of an organizational structure or its components, such as division or a department, its plans and policies, its financial controls, its method of operation and its use of human and physical facilities. It requires a change in attitude and aptitude as the modern management requires a business doctor to fine the symptoms and to diagnose the company's aliment at the right time to take corrective action. The following steps can be said to cover the entire gamut of management audit:
    i. Analytical and objective examination of the organization of the company, operation of various plans and policies etc., in all varied functional areas of the business to ensure optimum utilization of available resources.
    ii. Objective evaluation of performance of business.
    iii. Ascertaining the weakness prevalent in the organization so as to identity potential risks and dangers.
    iv. Identifying elements of waste, inefficiency, delay etc., which hamper the efficiency of operations.
    v. Reporting the efficacy of operation; plans, organizational plans and policies and control systems to the management.
    vi. Recommending measures for improvement, determent and remedy of disorders, if any present in the system.

    It is apparent from the above that management audit is a systematic fact finding process that examines, appraises, correlates and reports on the understanding and effectiveness of various plans and procedures of an organization.

    Thus the following emerge as the elements in management function, which need constant review by the management auditor.

    i. Plans and objectives
    The organizational set up of a company depends on its overall plans and objectives.
    ii. Organizational structure

A proper organizational structure is necessary to translate into action the plans and policies adopted by the management.

iii. Policies, systems and procedures

For effective management, sound policies and practices are essential.

iv. Means of operation

The means of operation should also be constantly reviewed, analyzed and appraised for effecting changes, where necessary.

v. Methods of control

In all the areas of business and industry, control measures are adopted. It is necessary to verify how far the measures of control have been adhered to by the different persons responsible.

vi. Human and physical facilities

The success of an industrial enterprise depends on proper manning and optimum utilization or physical facilities.

Techniques

A team of experts should conduct management audit because one individual cannot master the variety of skills required. This team may consist of the accountant, the operations research specialist, the industrial engineer and the social scientist.

The members of the management audit team should also be acquainted with salient features of various functional areas. Experiences of actual work situation would be useful.

To conduct its work properly, the management audit team should have a clearly defined authority from the management. Management audit cannot be conducted unless it is fully supported by the top management.

The management auditor is primarily concerned with the appraisal of performances in the various areas of management. Hence, he does not look for evidence to support definite accounting figures. Instead, he attempts to evaluate the processes and functions of management. In doing so, he uses the following techniques effectively:

i. Inquiry

A management auditor collects most of the evidence required by him by asking relevant questions and obtaining satisfactory answers to these questions.

ii. Examination

In many cases, the management auditor may have to conduct an examination of documents and records. This may be necessary in case the inquiry process yields certain information which needs corroboration or which suffers from internal contradictions.

iii. Confirmation

A management auditor may also obtain written or oral statements from various persons in order to confirm the information obtained by him.

iv. Observation of pertinent activities and conditions

In many cases the management auditor may have to rely upon his own observation of pertinent activities and conditions in the organization. A management auditor may prepare organizational charts and flow charts as a result of his observation of pertinent activities and conditions.

v. Correlation of information

The information collected through the various techniques has to be correlated so that proper conclusions can be arrived at. The management auditor has to compare the actual performance with the standers laid down or with the performances in the previous years. A good deal of skill is required in correlating the relevant information so as to reach meaningful conclusions.

b) The financial audit and operational audit are not mutually exclusive. These are interconnected. The object of financial audit is to look into the correctness of financial accounting data and compliance of internal control system. The operational audit on the other hand through appraisal, review and evaluation of the operating control records and management information systems, aims at better performance to achieve better profit. A clear distinction between operational audit and financial audit cannot be drawn in many cases. However the difference between the two may be stated as under:

	Financial Audit	Operational Audit
i.	To look into the correctness of financial data and records along with correctness of the accounting procedure followed.	To see that the financial accounting records have been properly designed and maintained to furnish the management with timely information to help them in judging the extent to which the profitability goals have been achieved.
ii.	To see that the internal control system has been working properly.	To see that the internal control system has been designed from the point of view of achieving better efficiency and whether the same have been functioning effectively.
iii.	To see that the credit control has been strictly followed.	To study the credit control system for suggesting better measure where considered necessary.
iv.	To see that all payments have been made with proper authorization and approval.	To study whether some expenditure of sizeable magnitude could have been avoided and reduced.

v.	To see that purchases have been made following the procedure approved by the management.	To study whether expenditure has remained within the budgetary provisions.
vi.	To see that any abrupt variations as for example in sales/purchases etc. in comparison with the immediate previous year/years are not due to any manipulation/irregularity.	To study the reasons for unfavorable/favorable variances.
vii.	To wee that proper records have been maintained for the fixed assets of the concern.	To study the return on assets employed along with the question of underutilization of assets and idle assets.
viii.	To see that the financial statements have been prepared following the established procedure and that the same display a true and fair view of the business transactions as also of the position of the concern as on particular date.	To examine whether the operational functions are in tune with the management objectives and to carry out the cost benefit analysis for helping the management in taking decisions.
ix.	To see whether scrap salvaged and surplus materials have been properly accounted for etc.	To study whether scrap/loss of material has remained within the permissible limits etc. and the methods of their disposal are bringing adequate revenue.

c) The operational auditor in an organization has to assess the effectiveness and efficiency of all the operational aspects of the business. He has to identity with the objectives of the management, he serves. The operational auditor's functioning is for management's guidance and control of business.

The control is the pivot of an organizational working. It is the brain of an effectively functioning business. If a business has all the latest tools and techniques of business functioning but lakes in control, it will not be able to achieve its objectives satisfactorily. Proper guidance, effective communication, good coordination, timely supervision etc. can help an organization more than mere use of expertise, theoretical knowledge and formulation of plans and policies. Therefore, control is a vital management process which directs all the operational activities towards achievement of objectives and goals of an organization. It enables the management to compare the performance with the standards laid down and take appropriate corrective and remedial measures.

An operational auditor has to review and analyze the control measures in operation in an organization. He has to ascertain and analyze the causes of variations, identify cause and effects of functioning of various resources employed on the quality and productivity, point out the ineffective controls and suggest improved means of attaining

the organizational aim. The operational auditor should review and evaluate the controls, keeping in mind the outlook of management, nature, size and complexity of operations and the business environment. He should appraise, as to how various activities like personnel relations, manufacturing, production, sales, expenditure etc. are controlled, the weak links therein if any, responsible persons or policies thereof, and suggest corrective and remedial steps. For this purpose, the operational auditor can verify the following:

i. Is this control of help to the management of the operation which is being audited?
ii. Is the cost of maintaining the control justified by the value of the business?
iii. Is there any duplication of work? If so, which is the better place to do it?
iv. Is there any duplication of controls?
v. Are the deviations in performance reported to the management on time?

Therefore, the operational Auditor has to ensure not only the presence of controls but also their efficacy. Due to this reason, operational audit function is an invaluable ingredient to ensure a credible and effective service to management, with far reaching implications.

Question:-

a) The internal auditor of a company with multiple 'strategic business units (SBUs)' noticed the following:

i. Same components of material are purchased by different units at different prices.
ii. Marketing personnel have been offering discounts/price reductions neither over catalogue/quoted prices beyond the authorized quantum/range without the prior approval of managing director nor were ratifications obtained subsequently.
iii. Some of the items of work relating to the manufacture of parts/sub-systems are sub-contracted to outside parties though there is capability and spare capacity available in the other sister SBUs within the company on the plea that it is cheaper to get it done from outside.

Draft the report of the internal auditor covering the above observations. Make assumptions, if necessary.

b) Give a check-list of five aspects for review of 'inventory' by a cost auditor.

Answer (a) (i)

Date: 28/12/2010

The Managing Director

XYZ Limited

Islamabad

Sir

Sub: Special Report of Internal Audit

In the course of conducting the internal audit for the last quarter, I have made certain observations, which relate to major policies and procedures followed by various units of the company. I submit this Report to highlight these findings and request you to take necessary steps to lay down suitable procedures and give directive to the different units and departments to streamline the procedures so as to enable the company to derive overall economies and benefits for the group.

My findings relate to three major aspects as under:

i. Purchases of components of materials by the different units:
ii. Offering of discounts or price reductions by Marketing personnel:
iii. Sub-contracting relating to manufacture of parts/sub-systems.

Now, I will deal with these subjects in detail:

i. **Purchases of components of materials by the different units**
Several cases have been observed where same components of material have been procured either form same or different sources by different units of the company at different prices. List of the specific cases found during the audit, is given in the Annexure attached
It is clear that the Company is incurring heavy expenditure in maintaining purchase departments or sections separately in all the Strategic Business Units (SBUs) of the Company but at the same time not deriving the benefits of the skills of one unit, for the benefit of other units.

ii. **Offer of discounts/price reductions by Marketing Personnel**
Several cases have been observed where different area personnel of marketing department have offered discounts and/or price reductions over and above the catalogue prices or specific prices quoted by company's units during negotiations. A detailed list of such cases is given for your ready reference in Annexure 2 attached.

The above finding clearly shows that the marketing personnel in this regard are not following the company's policies. This is not a healthy practice and should be rectified immediately lest things will become totally out of control resulting in loss of revenue for the company and unhealthy and unethical competition among the different marketing areas/divisions.

iii. **Sub-contracting for manufacture of parts and sub-system**

Here again, it has been observed that the production departments of the different units appear to follow different basis for sub-contracting work f\relating to procurement of parts or sub-systems. Discussions with the personnel concerned reveal that there is no clear cut policy laid down in this regard and they are making their decisions purely on the prices (rates) offered by the contractors. There is no system of drawing comparison with the other units of the company both with regard to the capability and capacity available or their costs/rates for the work. This has naturally resulted in sub-contracting manufacturing contracts to outside parties at the so-called lower rates even where the Company's other units have the capability and spare capacity. This is a very serious matter for the Company and immediate steps should be taken in this direction, to derive overall benefits to the Company through best utilization of the available facilities at the different units to the maximum.

How, I summaries below my suggestions to the management in respect of these three matters:

1. **Purchase**

   After making a detailed study of the various items of purchases made by different units, a common list should be evolved, which should include all items except specific items with technical specifications to be handled by individual units and the purchases may be centralized under one department for all units. This will result in large economies both in expenditure on personnel and purchase efficiency and prices resulting in large savings in material costs and also ensure that the same material is bought at the same price across all units of the company. This will enable the company to offer better prices for their products and be competitive.

2. **Discounts and price reductions**

   The Top Management and Marketing Department should lay down definite policies in writing in respect of prices to be offered to various outlets/customers and these should be followed strictly. Where any marketing personnel propose any exceptions, these cases should be specifically approved in advance and/or ratified by the Management without fail. This procedure should be rigidly complied with.

3. **Subcontracting for parts/sub-systems**

   Decisions in respect of outsourcing for parts/sib-systems should be made only by the Top Management of the Company. All such cases where parts of sub-systems are

proposed to be outsourced, the Units concerned should give the details to the Purchase Department of the Company, who in turn, will discuss first with the different units of the company regarding the possibility of manufacturing the same in house at any unit and then compare the costs worked out by them with those of outside parties before taking any decisions. The Unit of the Company which has spare capacity available, should be given a price, which is more than its marginal cost by may be less than that of the outside party's offer.

I shall be glad to discuss these issues in greater detail with you and look forward to meeting you in person as per your convenience.

Yours faithfully

ABC

Internal Auditors

Encl: As above

Answer (b)

An illustrative checklist for review of inventory by a cost auditor is given below:

a) Is the size of the inventory adequate or excess compared with the production program?
b) Is the provision most economical?
c) Does it ensure optimum order size?
d) Does it take into account the storage cost on the one hand and carrying cost on the other?
e) Does it take note of lead-time of the various items or groups of items?
f) Does the receipt and issue system cause any bottleneck in production?
g) Does it involve too many forms and too much paper work?
h) Is there any room for reduction of inventory cost consistent with production needs?
i) Is the inventory as per the priced store ledger and certified by the management as physically correct?
j) Is the same amount of attention and care given to monies translated into material things like raw materials, stores and supplies of all kinds as given to liquid cash?
k) Does the issue of raw materials makes the production in accordance with the standard schedule or otherwise, covered by authorized schedule?
l) Is the expenditure of consumable stores within the standard? If not, why not?
(Note: Illustrative List)

Question:-

a) **As a management auditor, how would you conduct a review of the following function:**
   i. **Sales promotion**
   ii. **Credit rating and control.**

b) **As an auditor, which are the ratios you would analyses in respect of the following:**
   i. **Liquidity.**
   ii. **Effectiveness in resource utilization**
   iii. **Inventory/stock levels.**

c) **An effective 'management information system' (MIS) is a must for management purposes. Enumerate the purposes served by the MIS.**

Answer: (a) (i)

Sales promotion

i. Whether appropriate and suitable techniques have been adopted for market survey and sales promotion in consonance with short-term and long-term objectives.
ii. Whether there is a sales promotion budget and if so, how is it determined?
iii. Scrutinizing the policies framed and followed pertaining to promotional policies.

Answer (a) (ii)

Credit Rating and Control

i. Whether credit worthiness of the customers is assessed before selling goods to them.
ii. Is the credit limit reviewed periodically?
iii. Whether the discount given is as per the price list.
iv. Whether any interest is charged for delayed payment.
v. Is the debtors ageing schedule prepared for verifying the outstanding and doubtful debts?

Answer (b) (i)

Liquidity Ratios

These ratios indicate the firm's liability to discharge its current/short term obligations. Some of the important ratios under this category are discussed as under.

a) Current Ratio: it is also known as the working capital ratio. It shows the relationship between current assets and current liabilities of an organization. The change in current ratio will indicate whether there is accumulation of stock, understatement of liabilities or manipulation in the value of stocks, debtors etc. A low current ratio indicates that the

organization is unable to meet its obligations in time. A high current ratio, on the other hand, indicates that either current liability is understated or there is manipulation in the value of stocks, cash or creditors.

b) Quick Ratio: It is ascertained by comparing the liquid assets to current liabilities. Liquid assets are current assets other than stocks. It is a good indicator of the liquidity of the enterprise or ability of the organization to meet its liabilities quickly/instantly when called upon.

Answer (b) (ii)

To ascertain the effectiveness in the use of resources placed at the disposal of the organization capital turnover ratios needs to be analyzed. Capital turnover ratio is computed by comparing sales to capital employed. A ratio indicates that the organization is making optimum sales by utilizing its funds properly. A low ratio may indicate that there is recession in sales or sales have been suppressed or that the value of any constituents of capital employed (net fixed assets + net working capital) might have been inflated. Auditor should critically analyze the ratio and find out the reasons.

Answer (b) (iii)

Inventory/Stock Level

Inventory/Stock turnover ratios are to be analyzed. Stock turnover ratio indicates that the sales are low resulting in an accumulation of stocks or that the levels of stock maintained are excessive in relation to sales.

Answer (c)

An effective MIS, inter alia, serves the following purposes:

i. To facilitate the decision making process in an organization by providing all levels of management with accurate, timely information to help the managers in selecting the best course of action.
ii. To provide managers at all level with planning and control tools.
iii. To help management in getting the required information for controlling the activities of the organization.
iv. To create a process of communication wherein information is recorded, stored and retrieved for decision-making, planning, operation and control in an organization.
v. To provide a system of people, equipment, procedures, documents and communications that collects, validates, operates, stores, retrieves and presents data for use in planning, budgeting accounting, controlling and other management process.

Question:-

a) **Outline the steps for performing the systems audit of 'preparation of dividend warrant' introduced by an organization as part of the programs for the computerization of company's secretarial functions.**
b) **Write notes on any three of the following:**
   i. **Protection of 'security of networks'.**
   ii. **Effects of computers on auditing**
   iii. **Norms and procedure for computerization**
   iv. **Role of database administrator.**

Answer:-

a) Regarding the Systems Audit of the Computer Application "Preparation of Dividend Warrants" the Systems Development Methodology adopted in the Computer Department would have to be verified for the following reasons:
   1. Are the best practices being followed for the development of the program and whether the Librarian is having records for the various versions of the program? For example, we need to verify the version number of the Dividend Warrant preparation program. The purpose of verifying the version number is to ensure that in a live environment only the correct latest version of the program is used. Also verifying the procedures for Change Management will assure us those changes to programs is made only under the specific authorization of the user endorsed by appropriate authority within the Computer Department.
   2. Verifying the procedures becomes all the more important if Dividend Warrant processing is given to third parties.
   3. The control practices followed by the third party Service Provider should be verified. Having verified the Management Controls. Environmental Control and Organizational Controls, the further steps to be followed for performing the Systems Audit of dividend preparation applications would be the following.

The steps are involved are:

1. **Verify Input Controls**
   The input will consist of the details of the various shareholders. The Mater Data would contain the name, address, nominee, or joint account holding details, as also income-tax status. Before the Dividend Warrant application program could be run in live environment the steps that would be taken would be to ensure all master records have been corrected, up to and including Share Transfers as approved by the last Share Transfer Meeting, and also all correspondence received regarding change of address, income-tax status etc.

2. **Providing Parameters**
   The program needs to be provided with certain parameter details like percentage of dividend being declared, income-tax to be deducted for the various types of Shareholders, e.g. Corporate Body, Non-Resident individuals, individuals.

3. **Checking Exemption from Tax Deducted at Source (From 15-H)**
   In the case of individuals not being liable to tax, whether Form 15-H has been provided and whether the same has been entered in the computer correctly. For this purpose, the computer listing of all of the cases where Form 15-H is purportedly have been provided should be printed out and this list should be physically verified with a hard copy of the 15-H forms. This would ensure two things:
   - The individuals, who would have had to pay tax, would have tax deducted.
   - Only those who have provided Form 15-H would be enjoying the privilege of not having the tax deducted.

Verifying the above would ensure the correctness of input regarding:

a) Shareholding:
b) Names and addresses: and
c) Tax status.

The application program/preparation of Dividend Warrants should be tested for these purposes.

The Systems Auditor should request for the appropriate computer program to be loaded on a separate computer. He should prepare an exhaustive Test Pack. The Test Pack will consist of a comprehensive data so that the logic of the program is extensively checked.

The program would now need to be tested. The computer, which has got a copy of the program loaded, would need to be utilized for loading this Test Data. The loading of Test data is done by creating a file of shareholders as envisaged in the Test Pack. After loading of the Test Pack, the necessary commands for commencing the processing should be given (this procedure can easily be picked up by discussing with the regular users of the Computer). Once the program commences processing, it would be processing one record at a time, as each of the records (detail of the shareholders) would need to be verified for its correctness and completeness. It the first record in the Test Data is processed, the computer should come out with an error message to say “No Shareholding”.

- For the second record, the message should say “minor but no guardian”.
- The Shareholder has no valid income-tax status.
- The shareholding is negative.

- Control totals do not tally – Control total.

Note: The contents of the error messages would also require to be fed into the program so that appropriate message as programmed would be picked up.

If for any reason, the results are not in line with the results as expected if the program were to function properly, we need to perform the following steps.

1. Ensure the Test Data has been entered into the Machine correctly. (This can be done by taking out a print out of the test pack and compare it with what was envisaged to be fed into the computer).
2. Note down the type of malfunctioning of the computer Program, for example, if record number 1 is processed without giving an error message, the program is not testing for nil balance of the shareholder, i.e. the Master file contains details of Shareholders who have ceased to be shareholders as they have sold out all their holdings.

At the end of the testing of the program and after evaluating the results, the Systems Auditor is able to conclude as to what types of "bugs" are in the program. Bugs, as we know are mistakes in the program.

The auditor should discuss this with the User Department and then discuss it with the developers of the program. Till such time as the program bugs are removed, that version of the program cannot be used, as it is not bug free. The Systems Auditor is required to prepare and submit a report based on his findings.

Answer (b) (i)

Protection of Security of Networks

Networks are protected by using:

- Appliances or software called "Firewalls" which restrict entry to outsiders based on security policy.
- Content Inspection & Intrusion Detection Systems, which monitor incoming packets and look for known or suspicions attack patterns. When they encounter suspicious code, they block the packets containing the same and thus protect the server.
- Antivirus software that is kept up-to-date with latest viral identities so that infected files can be identified and quarantined if not cured.

The security of Information in transit over the network can be taken care of by encryption, secure tunnels and tracking.

For this purpose, passwords need to be properly constructed and kept safe.

Answer (b) (ii)

Effects of Computers on Auditing

Computer systems have affected how auditors carry out their two functions viz.: evidence collection and evidence evaluation.

Changes to Evidence Collection

Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors confront a diverse and sometimes complex range of internal control technology that did not exist in manual system. For example, accurate and complete operation of a disk drive requires a set of hardware controls not used in a manual system. Similarly, system development controls include procedures for testing programs that would not be found in the development of manual systems. Auditors must understand these controls if they are to be able to collect evidence competently on the reliability of the controls.

Changes to Evidence Evaluation

First, auditors must understand when a control is acting reliably or malfunctioning. Next, they must be able to trace the consequences of the control strength or weakness through the system. In a shared data environment, for example, this task might be difficult. A single input transaction could update multiple data items that are used by diverse, physically disparate users. Somehow auditors must be able to trace the consequences of an error in the transaction input for all users.

Answer (b) (iii)

Norms and Procedure for Computerization

The computerized systems may be developed in-house or acquired from outside.

Whether developed in-house or bought out from third parties as readymade packages it is an accepted fact that the user needs would change and so the system would need to be modified. It is essential that from the point of ensuring that the systems are reliable, well-accepted best practices should be followed for systems development. This alone would ensure that software is not only developed properly but also maintained well thereafter. A need for a new system to be developed may arise under any one of the following conditions:

i. A new opportunity relating to an existing business process.
ii. A problem, which relates to an actual business process.

iii. A new technology that will enable an organization to take advantage of the technological developments.
iv. A problem associated with the technology currently in house.

The major components in software development are as follows:

i. Feasibility study.
ii. Requirements definition.
iii. If developed in-house, development, programming, alpha testing.
iv. If readymade package is acquired, acquisition of software and modification thereafter.
v. Beta testing, approval, implementation and post implementation.

Answer (b) (iv)

Role of a Database Administrator

The Database Administrator has to ensure the efficient operability of the Database Management System, including regular backups for safety, and fine-tuning of the database. The Database Management System (DBMS) may depend upon the Operating System (OS) & the Network Configuration. The Database Administrator hence has to work with the System Administrator and Network Administrator to ensure his/her objectives are met. In general, the roles include:

- Recoverability- Creating and testing Backups
- Integrity- Verifying or helping to verify data integrity
- Security- Defining and/or implementing access controls to the data
- Availability- Ensuring maximum uptime.
- Performance- Ensuring maximum performance given budgetary constraints
- Development and Testing Support – Helping programmers and engineers to efficiently utilize the database.

Question

a) **"Management audit should be applied to all factors of production and all elements of costs." Discuss briefly the points that should be kept in mind by an auditor while carrying out an appraisal of management methods and performance.**
b) **Write short notes on the following:**
   i. **Canons of financial propriety**
   ii. **Fixed asset turnover ratio**
   iii. **Current ratio**

Answer

a) Management Audit begins when a statutory financial audit ends. The statutory financial audit has a lot of limitations and therefore there is need for an independent appraisal of managerial performance at various levels including the top most level. Management

audit technique can be applied to all factors of production and to all elements of costs. It can also extend its activities to assess efficiency in planning whether in the preparation or in the execution stage. An appraisal of management methods and performance is to conducted with reference to the following:

1. Effectiveness and soundness of Organisational structure.
2. Whether the Organisational structure is in line with the plans and objectives of the organisation to accomplish its goals.
3. An assessment of management performance as to the extent to which the management plans, policies, systems and procedures proved a success.
4. What corrective and co-relative steps management should take to surmount the failures due to bottlenecks, deficiencies, internal friction, shortcomings, misappropriations and fraud.
5. To what extent management plans, policies and procedures warrant a dynamic change for future operation and planning of the business.
6. To what extent the available human and physical facilities can be effectively utilized and to what extent, extensions of facilities are required for organizational profitability and future growth.
7. Efficiency in financial planning to provide guidance, based on the latest development in critical assessment of capital budgeting, project analysis and profitability.
8. Is there an Organisational Manual which is useful and comprehensive?
9. Are the policies and procedures of industrial relations adequate, and effective?
10. Study of problems of co-ordination and co-operation among various levels of management.
11. Study the extent of an overall congenial climate to exist for better management of the business.
12. Study motivation and morale and their influence on business decisions.
13. Study the problems of complexity in running the business and the solution thereto.
14. Effectiveness of methods of control.
15. Effectiveness of management information system, particularly adequacy, clarity and promptness.
16. Proper climate for continuance and growth of the business.
17. Incentive plans for effective managerial performances.
18. Existence of management development plans for growth potential in executives to help business in choosing personnel for promoting to higher management as and when occasion arises.
19. To probe the effectiveness of the proper 'Span of control'.
20. To probe the balancing between authority and responsibility.
21. Whether a definite procedure is in existence to guide the conduct of every function.

22. Whether the policies and practices are operating effectively with regard to recruitment, selection, placement, promotions, transfer, terminations, job analysis, job evaluation, labour turnover, staff turnover, absenteeism, and lateness.
23. Whether there is an adequate policy for security and safety measures.
24. Adequacy of policy regarding salary and wage administration.
25. Whether the duties and responsibility are delegated properly and clearly defined.
26. In appraising the process of reorganisation to consider functional definition of authority and responsibility, chain of commands, span of control, division of jobs/activities, channels of contact, control, perpetuation, effectiveness, efficiency, and economy.
27. Extent of morale of the employees is existence.
28. Study the organizational personnel's indifference to organizational needs.
29. To what extent there is existence of 'resistance to change' and suggest remedial measures to overcome such resistance.
30. Existence of executive development training programme to create future leadership.
31. Whether Ali concerned in the organisation is well aware of the organizational plans and objectives.
32. Whether the goals are realistic this can be achieved or accomplished.
33. Whether realistic and attainable standards have been fixed to guide the 'Men at Work'.
34. Whether there is the existence of sound business judgment.
35. Management of Differences-the auditor may have to report about power and personality factor, management of difference viz., possible conflict of interest at the top management and executive management level so that the head of the organisation will be in a better position to discover and implement more realistic alternatives for dealing with it.
36. With regard to the human factor, or in other words, the human side of enterprise, the following factors are to be considered:
    - Formulation of personnel policies
    - Planning manpower requirement
    - Recruitment, training and development
    - Group development for executives, managers and trainees
    - Salary and Wage administration
    - Organisation: Structure
Function
Climate
    - Industrial relations
    - Collective bargaining

- Automation and its impact
- Incentives
- Employees active participation
- Suggestion scheme

37. Whether managers have freedom and opportunity to have their own creative thinking (creativity will provide the basis for business endeavor and activity).
38. Whether there is the existence of in-company meetings of the organizational personnel representing various departments to discuss problems and to decide the future course of action through better communication, internal control, methods, system and procedures.
39. Compliance with statutory and other rules and regulations affecting the organisation.
40. To what extent the suggestion scheme is effective if there is the existence of such a scheme.

Management audit technique can be applied to all factors of production and to all elements of costs. It can also extend its activities to assess efficiency in planning whether in the preparation or in the execution stage.

b) (i)

Canons of financial propriety

Every officer incurring or authorizing expenditure from public funds should be guided by high standards of financial propriety. Among the principles on which emphasis is generally laid are the following:

i. Every public officer should exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
ii. The expenditure should not be prima facie more than the occasion demands.
iii. No authority should exercise its power of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
iv. The amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type, should be so regulated that an allowance is not on the whole a source of profit to the recipient.
v. Public moneys should not be utilized for the benefit of a particular person or section of the community unless:
    - The amount of expenditure involved is insignificant, or
    - A claim for the amount could be enforced in a court of law, or
    - The expenditure is in pursuance of a recognised policy or custom.

The observance of canons of financial propriety is an important aspect looked into in the Propriety Audit.

b) (ii)

Fixed assets turnover ratio

This ratio shows the extent to which the investments in fixed assets contribute towards sales. The variations in the utilization of capacity are reflected in this ratio:

$$\frac{NetSales}{NetAssets}$$

b) (iii)

Current ratio

This shows the relationship between current assets and current liabilities of an organization. It is computed as:

$$\frac{Currentassets}{Currentliabilities}$$

The change in current ratio will indicate whether there is accumulation of stock, understatement of liabilities or manipulation in the value of stocks, debtors etc. A low current ratio indicates that the organisation is unable to meet its obligations in time. A high current ratio, on the other hand, indicates that either current liability is understated or there is manipulation in the value of stocks, cash or creditors.

Question:-

a) **"Internal control refers to the design and utilization of all the means whereby management is enabled most effectively to safeguard the company's assets, administrate the current operations and plan for the future." In the light of this statement, state the main components and objectives of an internal control structure in an organisation.**
b) **As a cost auditor, what steps would you suggest to the management that would improve the performance of the labour and that the labour cost is allocated to different jobs in an equitable manner?**
c) **"Operational audit is an extension of financial audit."**

Answer:

a) Internal control is an important tool of management to achieve organizational objectives effectively. It does not restrict itself to the accounting functions only, but extends to the administrative and other function also. With the effective utilization of internal control

structure prevailing in the organisation, management can most effectively safeguard the company's assets, administrate the current operations and plan for the future.

Internal control structure has three major components viz.

1. Control environment: The collective effect of various on establishing and enhancing, the effectiveness of specific policies and procedures.
2. Accounting systems: The methods and records established to identify, assemble, analyse, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.
3. Control Procedures: Policies and procedures that the management has established to provide reasonable assurance that specific entity objectives will be achieved.

The following are the main objectives of internal control structure:

1. To ensure the orderly and efficient conduct of business,
2. To ensure that transactions are executed in accordance with management's general or specific authorization,
3. To ensure that transactions are promptly and correctly recorded, in the appropriate accounts and in the accounting period in which executed, so as to permit preparation of financial information within a frame work of recognized accounting policies,
4. To ensure that access to assets is permitted only in accordance with management's authorization and recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences,
5. To ensure accountability for assets,
6. To ensure that the policies laid down are adhered to,
7. To ensure a confidence of reliability to the users of information,
8. To ensure timely corrective actions through feedback information,
9. To detect errors and frauds.

b) Proper utilization of labour and increases in productivity are receiving attention increasingly. Several productivity teams have emphasized importance of higher productivity. It is, therefore, essential to assess the performance efficiency of labour and compare it with the standard performance, so that labour utilization could be progressively improved.

As a cost auditor I would ensure that labour cost is allocated to different jobs with reference to time or job cards and also cover the following:

1. Cost Auditor should ascertain that selection of labour has been done by applying psycho-technical tests and new entrants are given sufficient training.

2. Incentive schemes have been introduced for motivation of workers e.g. bonus, etc. and proper records have been maintained.
3. If wages are paid on piece rate basis he should compare the piecework cards of workers with stock register and wages sheets.
4. Verify that the wages and salaries being expenditure on additions to plant, machinery or other assets have been allocated to asset concerned. Wages and salaries spent on capital heads of expenses are charged to separate head of account and not to the cost.
5. Salaries of supervisory staff, who are not specifically employed for a particular center, have been included under factory overheads.
6. System provides for a detailed record of time put in by each workman on each job and overtime is properly accounted for.
7. Idle time may arise due to productive causes, administrative causes and economic causes. He should enquire the causes of idle time to ensure that it is recorded and if the reasons are not satisfactory, mention the fact in his report.
8. Ensure that statements and cost sheets of cost department are reconciled with financial records.
9. He should check the Attendance Register, Leave Register and the Foreman's Register for first-hand information.
10. Ensure that job evaluation has been introduced and workers are put in proper grades for facilitating performance appraisal.

c) Financial audit and operational audit are not mutually exclusive. These are interconnected. However, a clear distinction between operational audit and financial audit cannot be drawn in many cases. The object of financial audit is to look into the correctness of financial accounting data and compliance of internal control system. The operational audit on the other hand through appraisal, review and evaluation of the operational control records and management information systems, aims at better performance to achieve better profit. The differences between the two may be stated as under:

	Financial Audit	Operational Audit
i.	To look into the correctness of financial data and records along with correctness of the accounting procedure followed.	To see that the financial accounting records have been properly designed and maintained to furnish the management with timely information to help them in judging the extent to which the profitability goals have been achieved.
ii.	To see that the internal control system has been working properly.	To see that the internal control system has been designed from the point of view of achieving better efficiency and whether the same have been functioning

		effectively.
iii.	To see that the credit control has been strictly followed.	To study the credit control system for suggesting better measures where considered necessary.
iv.	To see that all payments have been made with proper authorization and approval.	To study whether some expenditure of sizeable magnitude could have been avoided and reduced.
v.	To see that purchases have been made following the procedure approved by the management.	To study whether expenditure has remained within the budgetary provisions.
vi.	To see that any abrupt variations as for example in sales/purchases etc. in comparison with the immediate previous year/years are not due to any manipulation/irregularity.	To study the reasons for unfavorable/favourable variances.
vii.	To see that proper records have been maintained for the fixed assets of the concern.	To study the return on assets employed along with the question of underutilization of assets and idle assets.
viii.	To see that the financial statements have been prepared following the established procedure and that the same display a true and fair view of the business transactions as also of the position of the concern as on particular date.	To examine whether the operational functions are in tune with the management objectives and to carry out the cost benefits analysis for helping the management is taking decisions.
ix.	To see whether scrap salvaged and surplus materials have been properly accounted for etc.	To study whether scrap/loss of material has remained within the permissible limits etc. and the methods of their disposal are bringing adequate revenue.

Question:-

a) **Discuss briefly the basic check points for carrying out information systems audit in respect of any two of the following.**
   i. **Systems development methodology,**
   ii. **Operational controls,**
   iii. **Internal control in a computerised set-up.**

b) **Write notes on any three of the following:**

i. **Major components in software development**
ii. **Debugging a programme**
iii. **Devices/software systems used in network's security**
iv. **Encryption, secure tunnels and tracking**
v. **Construction of a good password.**

Answer: - (a)

i. In most companies System Development is badly handled. There is no documentation. The code is developed in great hurry and control aspects are given the go by. The accuracy of the processing and the legal compliance are left as open questions.
The main documents that should exist are:
- Functional requirement Specifications
- Software requirement Specifications
- Design Description
- Software code
- Test Plan
- Unit test results
- Integration test results
- Acceptance test results

The documents should be properly cross-indexed. The effect of a change made in the system should be well understood. It should not happen that, due to ignorance of the entirety of the business process and its ramifications, a change made in one area affects other areas, that too after a lapse of time.

Every time a change is made, a throughout testing should be done and documented.

The Auditor should get necessary evidence and comment on the lack of proper adherence to procedure.

ii. **Operations Controls**
The Auditor should observe the operations and comment on the drawbacks. Some of the possible scenarios are:
A. Anybody walks into the server room and has access to documents/media/machines.
B. Backup media not labeled properly and kept under lock and key.
C. One set of backup not regularly kept at another location
D. No documented and organized change control process. Software and data are arbitrarily changed.
E. Correction of errors not done by reversal of entry but by running dangerous script on the database backend.

F. Administrator passwords freely floating around and used by developers, operations staff and administrators.
G. Dirty network cabling with loose cables hanging around, hand crimped cables, cables not tagged for easy identification.
H. Switches/hugs lying loose on tables/hanging on walls.
I. Data controls not properly checked and filed.
J. Preventive Maintenance of Servers not done.
K. Machines working with covers kept off.
L. Media not properly labeled and recorded in media register.
M. Absence of gate passes culture: machines arbitrarily taken from/into computer rooms.
N. Unknown and untrusted floppies directly used without checking for virus.

The above scenarios speak of very casual IT setup. Such carelessness can result in serious downtime. Sensitive data can be pilfered from the servers. The IS auditor needs to highlight theses flaws as serious lapses.

iii. The information system assets of an organization must be protected by a system of internal control. Hardware can be damaged maliciously. Proprietary software and the contents of data files can be stolen or destroyed. Supplies of negotiable forms can be used for unauthorized purposes. Internal control in a computerised setup would encompass the following:
A. Separating incompatible duties;
B. Having competent and trustworthy personnel; and
C. Establishing clear definitions of duties.

By applying these principles, management can not only ensure the protection of hardware and software but the integrity of data can also be maintained before it is entered into the computer-based components of the information system.

Answer (b)

i. The major components in software development are as follows:
A. Feasibility study
B. Requirements definition
C. If developed in-house, development, programming, alpha testing
D. If readymade package is acquired, acquisition of software and modification thereafter.
E. Beta testing, approval, implementation and post implementation.

ii. Debugging a Program

Programs are written with the objective of giving instructions to the computer so that from the given input required output would be obtained. However, instructions to the

computer may not be conveyed properly. In such circumstances, the program would be defective and technically it is called that the programs has got "bugs" i.e. defects. It is the responsibility of the programmer to ensure that theses defects or bugs are removed and the instructions are conveyed properly. This process of removing the bugs is called debugging. It is the responsibility of the programmer to debug the programs he has written. He should ensure that the functionality of a program is in order and also that the built in control function as expected. There are various methods of debugging a program. By adopting these methods, a programmer would be able to locate the errors he has committed. He would rectify the error and test the program again and again fill such time the program function is as expected. The process of debugging a program is also called the testing of a program. For testing a program, an illustrative but exhaustive test data would be created i.e. a set of dummy data would be created so that all the logical paths in the program would be tested. Effectiveness of testing a program is very much dependent in creating an exhaustive test data. There are various types of testing. The programmers perform some tests. Some performed by the system analysts, some by the users.

iii. Devices/software system used in network's security

Networks are protected from attackers by using:

- Appliances or software called "Firewalls" which restrict entry to outsiders based on security policy.
- Content inspection & Intrusion Detection Systems, which monitor incoming packets and look for known or suspicious attack patterns. When they encounter suspicious code, they block the packets containing the same and thus protect the server.
- Antivirus software that is kept up-to-date with latest viral identities so that infected files can be identified and quarantined if not cured.

Organisation requires security experts to keep a constant watch on network security as attack patterns are dynamically changing. Recent studies have shown that most of frauds and damages have been done with insider collusion. Hence one needs to watch activities within and without.

Security of information in transit over the network is taken care of by encryption, secure tunnels and tracking.

iv. **Encryption, secure tunnels and tracking**

Encryption basically consists of transforming the information from an intelligible form to a non-intelligible form while sending. While receiving, the received information is transformed back to the original form. Modern encryption uses a pair of keys, one called "public" which is downloaded to the sender on initiation of the session. The sender's machine uses a mathematical algorithm to encrypt the information. This encrypted

information can only be decrypted with the "private" key, which the receiver has, on his/her machine. Thus even if a cracker traps the information, s/he cannot decrypt it. It is no use trying to decrypt by permutation because not even the fastest of computers can crack the encryption in years of continuous working!

Secure tunnels are established by a combination of encryption and authentication by a special signature. Tracking tools are available to monitor the entire path taken by the transmitted information. In the event of suspicious activity, the offending machine can be identified and reported.

v. **Construction of a good password**

In order to ensure that the access rights are properly followed, we have the system of passwords. The system Administrator assigns access rights to the users as required by their work. The user protects his/her access through passwords. Ideally, passwords should be minimum 12 characters long, having a combination of letters and numerical digits. Where permitted one can use special characters also. A good practice is to use strings such as "tRxcv#4328svxT" even if a person is looking over the shoulder of the user, the latter would not be able to recall the password. If the same password is around long enough, it can be compromised. Hence, many administrators force the users to change the passwords every week or fortnight. The old password cannot be sued after that date.

Question:-

Critically examine any four of the following:

i. **Management audit requires a business doctor to find the symptoms and to diagnose the company's ailment at the right time to take corrective action. The approach to management audit needs to be formulated accordingly.**
ii. **"Operational audit is a new phase of internal audit technique." While management audit is an audit of the management, operational audit is an audit for eh management.**
iii. **External auditor has no right to comment on the work of the internal auditor, nor there a need for any interaction between the two.**
iv. **The application of statistical sampling techniques by an auditor before expressing an opinion needs careful consideration of certain important factors and exercise of judgment almost at every stage by the auditor.**
v. **A plethora of report and returns are generated /received by mangers at different levels daily, weekly, etc., from the operating and functional department. Hence, there is hardly any necessity for a separate department/system for 'management information'.**

Answer:

i. The statement made is correct and apt. Management Audit requires an inter-disciplinary approach since it involves a review of all aspects of management function. It requires a change in attitude and aptitude and as such the need for a "business doctor". The following steps can be said to cover the entire gamut of management audit to examine and detect symptoms and diagnose the weaknesses and suggest remedial action.

   a) Analytical and objective examination of the organisation of the company, operation of various plans, policies etc. in all varied functional areas of the business to ensure optimum utilization of available resources.
   b) Objective evaluation of performance.
   c) Ascertaining the weakness, identifying potential risks and dangers.
   d) Identifying elements of waste, inefficiency, delay etc., which hamper the efficiency of operations.
   e) Reporting the efficiency of operations, plans, Organisational plans and policies and control systems to the management.
   f) Recommending measurers for removing deterrent and disorders, if any present in the system.

   It is apparent from the above that management audit is a systematic fact finding process that examines, appraises, correlates and reports on the understanding and effectiveness of various plans and procedures of an organisation.

ii. There are certain similarities between Operational Audit and Internal Audit. Operational audit is in the form of a scientific tool applied by the auditor to:

   a) Given an assurance to the management that the management controls are efficient and effective:
   b) Operational activities are in accordance with the objectives of organisation.
   c) Management information Systems in the form of reporting, evaluation and review are effective to attain organizational goals and objectives.
   d) It involves the application of all the basic audit skills of penetrating examination of relevant evidence, informed analysis of findings and making unbiased interpretive judgment from an impartial viewpoint.

Internal audit also covers the above areas and provides a service to the management by evaluating the controls in existence, pointing out weakness and suggesting remedial action.

However, a comparison of the two brings out the following distinctiveness of Operational Audit:

   a) Internal audit is an independent appraisal activity within an organisation for the review of operations as a service to the management. Operational Audit is

concerned with all operations of business whether financial or non-financial like production, purchase, sales, personal etc., operational audit is basically concerned with the operations of a business.

b) Internal Audit is a managerial control, which functions by measuring and evaluating the effectiveness of other controls. As such Internal Audit is concerned not only with operations of the business but also with managerial control. Operational Audit aims at improving future business operations by concerning the audit with all aspect of management. Hence, it is a new phase of internal audit technique.

c) Internal audit is concerned first with the financial monitoring systems. However, many important activities are often better monitored initially in non-financial monitoring systems lead towards operational auditing. This is the systematic appraisal of major functional areas of business against corporate and industry standards with the objective of assuring management that its aims are being carried out and identifying conditions capable of improvement.

A comparison of the nature of operational Audit vis-à-vis Management Audit brings out the following distinctions:

Operational Audit is concerned with all operations of a business whether financial or non-financial and is basically aimed at finding out whether all operations of the business in the areas of manufacturing, marketing, personnel, financial services etc. are being carried out properly. It is to point out any lacunae in the operations of any of its activities. Operational Audit is an audit for the management.

Management audit covers all aspects or processes of management including planning, organisation, control etc. of a business. Its aim is to find out the efficacy of the control systems in operation and in business at any given time. Therefore, management audit can be considered as audit of the management. Thus the statements made are correct.

iii. The statement is not correct. The external auditor i.e. the statutory auditor cannot undertake 100% check of all the transactions of the company due to time and cost constraints. He conducts test checks and where there is an efficient and effective internal audit system he can rely on the adequacy and working of the internal control systems, books and records and plan his own audit work concentrating on important areas. However, the ultimate responsibility will continue to be that of the external auditor for expressing an opinion on the Financial Statements and other relevant matters and he cannot claim immunity for neglect of duty on the plea that he placed reliance on the work of internal auditor.

Co-ordination and co-operation between the External and Internal Auditors is very essential and should be based on:

a) Periodic efforts to discuss matters of mutual interest:

b) Access to each other's programmes, files and papers:
c) Interchange/exchange of correspondence and reports:
d) Common understanding of audit techniques methods etc.

In order to maximise the use of resources the External Auditor should evaluate the performance of Internal Auditor prior to determining the workload to be undertaken by him

The important criteria are as follows:

a) Internal Audit done by persons with sufficient technical training and proficiency and appropriates Organisational status is given to the Internal Auditor.
b) Degree of independence of the Internal Audit function and any constraints imposed by the management on the Internal Auditor.
c) Internal Audit Work is properly planned supervised, reviewed and documented.
d) The scope and extent of coverage.
e) Review of the Internal Auditor's Working Papers and note books to see that-
   - Related audit programmes are adequate for external auditor's use.
   - Appropriate evidence was obtained to have reasonable basis for conclusion.
f) Effectiveness of follow-up of regular internal audit exercises.

Thus, the External Auditor can comment on the work of the Internal Auditor and Co-ordination and Co-operation between the two is essential.

iv. Statistical sampling is a technique which assists an auditor in his procedural audit by enabling him to draw conclusions about the characteristics of the items under consideration/examination (generally referred to as 'Population') based on the sample of items actually examined by him. For these conclusions to be valid, it is necessary to indicate the margin of error. Sample sizes are determined with the assistance of specially prepared tables or graphs. Before these may be put to use, a number of factors should be determined by the auditor, which are as follows:

(i) Population size; (ii) level of confidence required; this must be related to materiality and represents (conversely) the measure of risk that the sample will be unrepresentative; (iii) the estimated error rate in the population being examined based on past experience and initial evaluation of client's system; (iv) The percentage rate of errors in the sample examined which is regarded as acceptable by the auditor. Additionally, it is necessary that actual selection be made on random basis.

The statement made is correct. Application of the technique requires exercise of judgment by the auditor almost at every stage. It is systematic and requires rigid compliance of applicable requirements. It enables the Auditor to measure the risk he is undertaking is expressing a particular opinion and provides a scientific basis for the same. The following factors should be noted in this regard:

a) There should be sound internal control in force capable for imparting reliable accounting data and checking of deviations from the prescribed procedure;
b) The area of operation must be large enough to justify the application of statistical sampling techniques;
c) There should not be wide variation in the field of data used;
d) The transactions should be of repetitive nature;
e) The result obtained through statistical method should be capable of evolution.
f) Sample size is linked to the precision and confidence level (or vice-versa) the sample size must be increased.

v. The statement is not correct. As stated there may be in existence a procedure for the preparation of periodical reports. However, there are several occasions when right type of information analysis in the required manner is not available at the right time to enable prompt managerial action. Some of the reports may contain needless information and the recipient's ay not even read some. Therefore, there is a need for a Management Information System using formalized procedures to provide managers at all levels with adequate and up-to-date information from all relevant sources for the purpose of planning and controlling the activities for which they are responsible i.e. managerial decision-making:

MIS refers to a comprehensive and coordinated set of information system – a formal system providing requisite and meaningful information from various operating divisions to different levels of management and control. MIS is a systematic procedure to provide relevant information, at the right time, in right format, to all levels in the organisation for providing support to decision-making activities. An effective MIS serves the following purposes:

a) Providing accurate and timely information to assist managers in choosing the best course of action:
b) Providing planning and control tools.
c) Providing information for controlling organisation activities.
d) Creating a process of communication wherein information is recorded stored and retrieved for decision –making, planning, operating and control of an organisation.
e) Providing a system of people, equipment, procedures, documents and communication that collects, validates operates, stores, retrieves and presents data for use in planning, budgeting, accounting, controlling and other management processes.

In view of the above, formalized MIS is a must and preferably a distinct Department for organizing and operating the MIS is needed.

Question:-

a) **Write a note on Organisational need for management audit.**
b) **Distinguish between management audit, financial audit and internal audit.**

Answer:-

a) **Organisational Need for management audit**

In connection with the control of overall performance, management audits are becoming increasingly significant. Just as most companies make it a point to have their accounts audited at least once a year, some of the more progressive companies have recognised the importance of management audit. These audits are substantially different from those performed by Chartered Accountants and are not concerned with the verification of financial data. They are performed either for the top management or the stockholders, or for owners. Management audit provides a device for surveying the management of the enterprises critically and objectively from the broadest possible point of view. They start where the balance sheet audit ends and are concerned with the examination of the organization and the operations of the enterprise from every aspect. At time, such an audit is undertaken by the management itself and sometimes outside aid is called upon.

The growing number of professional managers, the continuing separation of ownership form management and the wider distribution of stockholders will sooner or later make a certified management audit mandatory as in the case of an audit by a Chartered Accountant. A prerequisite to this development is that generally recognized principles of making the certification have achieved professional status with necessary professional training and proper accredition.

Management Audit can be perceived as effective as management services of consultancy firms because the auditor will become an active adviser by offering solutions for management problems and help in the lookout for a successful organizational existence and growth.

b) **Distinction between Management Audit, Financial Audit and Internal Audit**

Management Audit	Financial Audit	Internal Audit
Nature & Purpose		
Management audit is concerned with finding out the efficacy of the control system in operation. It reviews whether the policies lay down and decisions taken were in organization's interest and	The auditors review the financial statements of a company to express an opinion as to whether they reflect a true and fair view of its state of affairs and working period. The main purpose of an independent	Internal audit is basically concerned with ensuring control of various operations and effective control measures. Internal audit is complementary to statutory audit.

were effective. The purpose of management audit is to assess whether the integrated management systems, which are required to fulfill the contractual and legal obligations for the company to its customers and community, are being effectively implemented and the true and fair presentation of the results of such and examination is attained.	financial audit is to determine whether the financial statements represent fairly the actual financial position and working results of an organisation.	
Scope		
The management audit concentrates upon the main sources of decision-making in a firm, which can achieve effective and impressive results for profitability. It covers mainly management areas.	The auditor's certificate depends on verification of the Profit and Loss Account and Ledger Accounts with reference to original documentary evidence.	Normally covers audit of routine financial transactions to ensure that no irregularities would occur within the organization in any area where finance is involved and to judge the efficacy of systems of internal control.
Features		
Audit of management policies and their adequacies to meet corporate objectives. Audit of procedures, organization and methods to confirm proper implementation of policies and rules.	Looking into the correctness of financial data and records along with correctness of the accounting procedures followed. Seeing that established accounting systems and procedures have been complied with.	Covers mainly financial transaction, through can be extended to management areas in the absence of management audit.
Management audit covers the entire gamut of activities whether operations, general or control activities for which only the top management is responsible for.	Seeing that financial statements have been prepared following the established procedures and that the same display a true and fair view of the business transactions as also of the position of the concern as on a particular	a) Routine check of financial transactions b) Ensuring efficiency of performance c) Preventing irregularity d) Continuous audit for internal reporting, through can be conducted by outside

	date.	agencies e) Requirement under CARO f) Ensuring internal control measures are followed and are effective.
Areas		
Organisation, methods, procedure, controls, techniques, systems and functional areas such as purchase, production, sales, personnel and inventory management.	All cash transactions-receipts and payments, wages and salaries, purchase and sales, stocks and work-in-progress, physical verification of assets (current and fixed).	Sales, purchase, receipts, payments, stores and stock, production and performance efficiencies, including physical performance (quantitative and qualitative) and physical verification of assets.
Qualifications of Auditor		
The statue does not lay down any qualification for a management auditor, but he must be a senior person with enough experience since management audit covers all the functional areas of management. The qualifications of a management auditor are difficult to be prescribed. Ideally, a candidate with multi-disciplinary approach is best suited for the job. It could also be a team of persons specializing in different disciplines.	The qualifications required for appointment of statutory auditor have been specified under Ordinance 1984 of the Companies Act, 254.	It is performed by the employees of the company, drawn from internal audit department. There is no statutory qualification. Auditor should be a man of experience and intelligence, with a logical mind and analytical approach. His exposure has to be in areas of accounts/finance. It is a continuing audit which goes on the year round, at specified and regular intervals.
Periodicity		
There is no such defined period. It purely depends on the management. Normally it is held once in 2-3 years.	Statutory financial audit is conducted every year.	It is a continuous process.
Reporting		

The management audit report is meant for top management. The report is submitted to managing director or executive director through at times the report is submitted to an audit committee of the board of directors.	The financial auditor has to make a report to the members of the company i.e. share-holders.	The internal audit report is meant for top management. A copy of the report department concerned.

Question:-

a) Is a system audit an evaluation of adequacy of controls? Briefly discuss the controls which are to be reviewed.
b) Discuss the objectives of information systems auditing.
c) "Computer systems have affected how auditors carry out their basic functions of evidence collection and evidence evaluation"

Answer:-

a) With the increasing use of computer-based systems in enterprises, the complexity of system and risk of errors, sabotage and fraud have increased. Information Systems Audit, unlike other conventional audits viz. Financial Audit and Technical Audits is not restricted to audit or reported items only. It has to take into cognizance the choice, use and risk of technology, look at the realities of business processes and the ever-changing legal framework.
The scope of Information System Audit covers the entire Information System Management Process and includes review of the entire design and development process, technology choice, processes employed to assess risks and losses that could accrue to the system, the possibility of computer frauds, the care taken in managing change to systems, extent of testing and reliability of the system.
"Control objectives of Information Technology" (COBIT) lays down that "Information" needs to have the following quality attributes: effectiveness, efficiency, confidentiality, integrity, availability, compliance and reliability. Information System Auditor may be classified as follows:
1. Management control comprises of:
    A. Security Policy and Standards
    B. Constitution of Steering Committee
    C. Business Continuity Planning
    D. Systems Development Methodology.
2. Operation Control Comprises of:

A. Monitoring physical assets
B. Ensuring adequate environmental controls such as Air-conditioning (online UPS functioning all the time with Backups and proper earthling).

3. Organisational Control Comprises of :
   A. Defining roles, responsibilities and duties of user-Department and I.T. Department.
   B. Defining roles, responsibilities and duties within the I.T. Department such as developers, operators and administrators.
4. Application Control Comprises of :
   A. Each of the computer systems and sub-systems must have its own set of controls for input, processing and outputs. Processing controls should also ensure checks for legal compliance.
   B. While performing the audit, each of the controls needs to be studies for existence and adequacy.

b) Information systems auditing or systems audit is the process of collecting and evaluating evidence to determine whether a computer system safeguards assets, maintains data integrity, allows organizational goals to be achieved effectively, and uses resources efficiently. Some of the objectives of information systems auditing are discussed as under:

I. Asset Safeguarding Objectives

The information system assets of an organization include hardware, software, facilities, people (knowledge), data files, system documentation, and supplies. Like all assets, they must be protected by a system of internal control. Hardware can be damaged maliciously. Proprietary software and the contents of data files can be stolen or destroyed. Supplies of negotiable forms can be used for unauthorized purposes. These assets are often concentrated in one or a small number of locations, such as a single disk. As a result, asset safeguarding becomes an especially important objective for many organizations to achieve.

II. **Data Integrity Objectives**

Data integrity is a fundamental concept in information systems auditing. It is a state implying data has certain attributes: completeness, soundness, purity, and veracity. If data integrity is not maintained, an organization no longer has a true representation of itself or of events. Moreover, if the competitive advantage. Nonetheless, maintaining data integrity can be achieved only at a cost. The benefits obtained should exceed the costs of the control procedures needed.

III. **System Effectiveness Objectives**

An effective information system accomplishes its objectives. Evaluating effectiveness implies knowledge of user needs. To evaluate whether a system

report information in a way that facilitates decision making by its users, auditors must know the characteristics of users and the decision-making environment.

Effectiveness auditing often occurs after a system has been running for some time. Management requests a post audit to determine whether the system is achieving its stated objectives. The evaluation provides input to the decision on whether to scrap the system, continue running it, or modify it is some way.

Effectiveness auditing also can be carried out during the design stages of a system. Users often have difficulty identifying or agreeing on their needs. Moreover, substantial communication problems often occur between system designers and users. If a system is complex and costly to implement, the design is likely to fulfill user needs.

IV. **System Efficiency Objectives**

An efficient information system uses minimum resources to achieve its required objectives. Information systems consume various resources: machine time, peripherals, system software, and labour. These resources are scare, and different application system usually competes for their use.

The question of whether an information system is efficient often has no clear cut answer. The efficiency of any particular system cannot be considered isolation from other systems. Problems of sub optimization occur if one system is "optimized" at the expense of other system. For example, minimizing an application system's execution time might require dedication of some hardware resource (e.g., a printer) to that system. The system might not use the hardware fully, however, while it undertakes its work. The slack resource will not be available to other application system if it is dedicated to one system.

System efficiency becomes especially important when a computer no longer has excess capacity. The performance of individual application system degrades (e.g., slower response times occur), and users can becomes increasingly frustrated Management must then decide whether efficiency can be improved or extra resources must be purchased. Because extra hardware and software is a cost issue, management needs to know whether available capacity has been exhausted because individual application systems are inefficiency or because existing allocations of computer resources are causing bottlenecks. Because auditors are perceived to be independent, management might ask them to assist with or even perform this evaluation.

c) There is no change in the fundamental nature of auditing due to computerization and all pervasive Information Technology. Auditors must still provide a competent,

independent evaluation as to whether a set of economic activities have been recorded and reported according to standards or criteria. However, computerization has affected the basic function of collection and evaluation of evidence as discussed below:

Changes to Evidence Collection

Collecting evidence on the reliability of a computer system is more complex than collecting evidence on the reliability of a manual system. There is a diverse and sometimes complex range of internal control technology e.g. accurate and complete operation of a disk drive requires a set of hardware controls not used in manual system. Similarly, system development controls include procedures for testing programmes that would not be found in the development of manual systems. Auditors must understand these controls if they are to be able to collect evidence competently on the reliability of the controls.

Understanding the control technology is not easy with the rapid evolution and changes in hardware and software technology control. Auditor has to keep himself abreast with these developments/changes if has to evaluate the reliability of communication networks competently.

The continuing evaluation of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. In some cases auditors may be able to collect audit evidence using manual means. Thus they need computer systems themselves if they are to be able to collect the necessary evidence.

The development of generalized, audit software occurred, for example because the auditor needed access to data maintained on magnetic media. New audit tools are required in due course if auditors are to be able to evaluate the reliability of controls in data communication networks competently. Unfortunately the development of theses audit tools usually lags behind the development of the technology that must be evaluated. In the meantime auditors are often forced to compromise in some way when performing the evidence collection function.

Changes to Evidence Evaluation

Due to the increased complexity of computer systems and internal control technology, it is also more difficult to evaluate the control strengths and weaknesses for the overall reliability of the systems. First auditor has to understand when a control is acting reliably or is malfunctioning. Next they must be able to trace the consequences of the control strength or weakness through the system. In a shared data environment this task might be difficult.

A single input transaction could update multiple data items that are used by diverse, physically disparate users. Auditors must be able to trace the consequences of an error in the transaction input for all users.

In some ways auditors are also under great stress when evaluating the evidence in the computerized set-up. The consequences of error could be more serious than that in a

manual system. Errors in computer system tend to be deterministic i.e. an erroneous programme will always execute incorrectly. In a manual system errors tend to occur stochastically e.g. periodically a clerk prices an inventory item incorrectly. Errors are generated at high speed and the cost to correct and rerun programmes can be very high while feedback can be given to a clerk committing an error in the manual system, in computer programmes can involve extensive redesign and reprogramming.

Thus, internal controls that ensure that high quality computer systems are designed, implemented, operated and maintained are critical. The onus is on the Auditors to ensure that these controls are sufficient to maintain asset safeguarding, data integrity systems, effectiveness and efficiency and they are in place and working reliably.

Question:-

Critically examine any four of the following:

i. **Management audit is a comprehensive critical review of all aspects on processes of management.**
ii. **Management audit begins when a statutory financial audit ends.**
iii. **Operational audit is a scientific tool and technique adopted by the auditor in a progressive business concern.**
iv. **An operational auditor has to review and analyse the control measures in operations in an organisation.**
v. **Efficiency audit is to ensure that every rupee invested in capital or other field gives the optimum return.**

Answer:

i. Management Audit assesses whether the integrated management systems which are required to fulfill the contractual and legal obligations of the company to its customers and community are being effectively implemented.

Management Audit is concerned with appraisal of total performance of management of the company. The area and scope of management audit are very wide and comprehensive. It is a tool in the hands of top management.

Management audit includes cost management functions, and also takes care of economic environment, social accounting and reporting. Management audit is a technique of assessing how effectively the executives can plan, organize, direct and control and ensure effective and efficient use of available resources like men, material, machines, money and methods for achieving the objectives. Thus it is an audit of various functions and policies to use economic resources placed at its disposal in an efficient manner.

ii. The main purpose of an independent financial audit is to determine whether the financial statements represent fairly the actual financial position and working results of an organisation.

However, the purpose of management audit is to assess whether the integrated management systems which are required to fulfill the contractual and legal obligations for the company to its customers and community are being effectively implemented and the true and fair presentation of the results of such an examination is attained.

The statutory financial audit has a lot of limitations and therefore there is need for an independent appraisal of management performance at various levels including the top most level.

Financial audit takes care of the protective aspect of the business and it does not normally carry out any constructive appraisal function of business operations. In financial audit the Auditor's certificate depends on verification of the Profit and Loss Account and Ledger Accounts with reference to original documentary evidence.

However, the management audit concentrates upon the main sources of decision making in a firm, which can achieve effective and impressive results for profitability. In other words, the report of management auditor contains the auditor's opinion on the performance of the management function at all levels.

iii. Operational audit is a scientific tool and technique adopted by the auditor in progressive business concerns. It is a more of a technical analysis for appraisal and review rather than a financial cum accounting analysis under financial audit. In operational audit the audit functioning objectives reach out beyond the financial control aspect into the operating area of the business. It aims at improving future business operations by concerning the auditor with all aspects of management. This is a new phase of internal audit technique.

Operational auditing is auditing the performance for management and this would embrace the following:

a) Auditing the operational activities to achieve better efficiency and economy.
b) Auditing the organizational objectives to achieve improved profitability.
c) Auditing the management information and control system for achieving better effectiveness.

iv. An operational auditor has to review and analyze the control measures in operation in an organisation. In other words, he has to ascertain and analyze the causes of variations in the functioning of various resources employed on the quality and productivity, point out the ineffective controls and suggest improved means of attaining the organizational aim. For this, he has to be familiar with the various types of control measures functioning in an organization like internal control, management control, executive control, internal accounting control, management information control etc. the operational auditor should review and evaluate the controls, keeping in mind the outlook of management, nature, size and complexity of operations and the business environment. He has to appraise, as to how various activities like personnel relations, manufacturing, production etc. are controlled, weak links if any and any remedial

actions, which can be taken. For this purpose, the operational auditor can verify the following.

a) Is this control of help to the management of the operation which is being audited?
b) Is the cost of maintaining the control justified by the value of business?
c) Is there any duplication of work? If so, which is the better way to do it?
d) Is there any duplication of controls?
e) Are the deviations is performance reported to the management on time?

Therefore, the Operational Auditor is vested with a responsibility of ensuring not only the presence of controls but also their efficacy.

v. Efficiency audit presupposes certain levels of efficiency at which the operations are being carried on. Efficiency audit establishes relationship between input and output. It measures the efficiency with which the resources employed are being used. It is the application of a basic economic principle, namely, resources flow into the most remunerative channels. Its main purpose is to ensure that all business operations are being carried on in the most appropriate manner.
Efficiency audit starts with the examination of the plan and extends to the comparison of actual performance against the plan and investigation with the reasons for variances. Further, efficiency audit is directed towards the assessment of whether or not corporate plans have been efficiently and economically executed. Therefore, it is concerned with every functional or operational area of the organisation to find out whether resources of the organisation, both physical and economic are being utilized in an effective and efficient manner to achieve the objectives of the company.

Question:-

a) The chief of an internal audit department has been asked by the managing director of the company to ensure that no qualifications are made by the statutory auditor in his report under the Companies (Auditor's Report) Order, 2003. What are the points that need to be examined and reported to the managing director by the chief of internal audit in respect of the following items:
   I. Fixed assets:
   II. Inventory; and
   III. Loans granted or taken?

b) Discuss the advantages and limitations of inter-firm comparison.

Answer:-

a) The points to be examined and reported by the chief of internal audit in respect of the following are:
   I. Fixed Assets

Check:

A. Whether the company is maintaining proper records showing full particulars, including quantitative details and situation or fixed assets;
B. Whether these fixed assets have been physically verified by the management at reasonable intervals. Also is there any material discrepancies noticed in such verification. If so the same are to properly dealt with in the books of account;
C. If a substantial part of fixed assets have been disposed of during the year, whether it has affected the business of the going concern.

II. Inventory

Check:

A. Whether physical verification of inventory has been conducted at reasonable intervals by the management.
B. Whether the procedures of physical verification of inventory followed is reasonable and adequate in relation to the size of the company and the nature of its business. If not what are the inadequacies and what are the corrections needed.
C. Whether the records of inventory are maintained properly and material discrepancies noticed on physical verification have been properly dealt with in the books of accounts.

III. Loans granted or taken

Check:

A. Whether the company has either granted or taken and loans secured or unsecured to/from companies, firms or other parties covered in the register maintained under Section 301 of the Companies Act, 1956 and if so the number of parties and amounts involved in the transactions should be given.
B. Whether the rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured are prima facie prejudicial to the interests of the company.
C. Whether the payment of the principal amount and interest are also regular.
D. If overdue amount is more than one lakh, whether reasonable steps have been taken to recover the dues or pay the amounts owed in respect of principal and interest.

Apart from the above, it should also be verified whether there is an adequate internal control procedure commensurate with the size of the company and nature of its business, for the purchase and sale etc. Also, if there is a continuing failure to correct major weakness in internal control, the same have to be reported.

b) Inter-firm comparison is a technique of comparing the performances, efficiencies, costs and profits of various concerns in an industry for assessing its own performance and ascertaining the reasons for any difference in performances/efficiencies etc. Inter-firm comparison has been used on a large scale with the objective of making choice of investment by potential investors or to assess the stage of performance of a particular organisation vis-à-vis that of others.

Advantages of Inter-Firm Comparison

An inter-firm comparison of financial performance is a highly useful tool for understanding the behaviour of the financial variables for measuring the efficiency of the different units in the industry. It pinpoints the stronger and weaker units and also indicates the trends of improvement or deterioration for them. It highlights the factors beyond the control of the improvement or deterioration for them. It highlights the factors beyond the control of the industry which constrain performance of various units and require immediate attention of the Government and other agencies interested in the growth of the industry. The investor relies on inter firm comparison for determining the status of security of investment as also the returns in the form of dividends. For the workers and their unions inter-firm comparisons provide a clear idea of the relative capacity of the firm in question in terms of wages, wage scales, production bonus etc, as well as the relative efficiency of workers in particular firm vis-à-vis other firms in the industry or the same class of workers.

The main advantages of inter-firm comparison are the following:

i. The extent of weakness or potential improvement is highlighted by the comparison and each firm may try to improve the productivity of its factors of production.
ii. The manufacturer is able to update ratios with trends and to maintain and improve his position in relation to that of other manufacturers.
iii. It ensures unbiased and specialised reporting on particular problems of the firm.
iv. It develops cost consciousness among the participating firms and they are cautious in this respect at all levels of management.
v. It helps Government in effecting price regulations.
vi. It enables the business firms to evaluate the data relating to operations of the competitors, especially their cost structure, revenue realizations, profitability etc.
vii. Sound information as opposed to vague reports and the necessary standardization of methods used to arrive at such information reduces the possibility of unfair competition.
viii. It helps the Government, regulatory agencies and researchers in getting extremely useful data and quantitative information which is used to improve policies and conducting in-depth analytical studies and research.

ix. It stimulates self-criticism and also identifies the various responsibility centres for various operations and their economic evaluation in terms of corporate objectives.

Limitation of Inter-firm Comparison

In spite of the various advantages, inter-firm comparison is not free from draw backs. The following limitations of inter-firm comparison may be noted:

- **i.** If information or ratios are not properly collected before they are used, comparison will be rendered difficult and absurd results will emerge.
- **ii.** Most of the member firms do not disclose the relevant data as they consider it confidential. Thus, the information supplied may not always be reliable for comparison or decision making purposes.
- **iii.** The middle management may not be convinced with the utility of inter-firm comparison or decision making purposes.
- **iv.** Unless there is a uniform costing system among the members, the information may not be reliable for the purposes of comparison as different members may imply different things by the usage of same terms.
- **v.** In the normal course, a suitable base for comparison may not be available.
- **vi.** In any comparison, time factor is an important element, any inter-firm comparison, which ignores this, will lead to misleading results which are not comparable and as such the very purpose of this exercise will be frustrated.
- **vii.** The inconsistencies in financial reporting are totally ignored. No adjustments are made for changes in the prices. No attention is given to the level of technology and technological developments. Generally, there is a lack of common valuation method in different units to be compared. All these aspects adversely affect the reliability of the results obtained by inter-firm comparison.

Question:-

a) Draft an internal control questionnaire on purchases.

b) Comment on the following:

- **i. Zutshi Ltd, appointed Mohan as cost auditor on 15th June, 2005 only. His acceptance was however received on 20th July, 2005. The company furnished cost accounting records for the year ended 31st March, 2005 to the cost auditor on 15th September, 2005. The report was eventually submitted on 25th October, 2005 resulting in delay.**
- **ii. Cost auditor of Anand Ltd. furnished the clarifications on the cost audit report for the year ended 31st March, 2004 on 10th December, 2004. The**

communication from the Central Government seeking clarifications was received by the cost auditor on 16th October, 2004.

iii. **The annexure and proforma prescribed was signed by the managing director. The Company Secretary was on leave. Other directors were not available and approval of the Board of directors could not be obtained as required under the Cost Audit (Report) Rules, 2001.**

Answer:-

a) Questionnaire on purchase

1. Is the store department's purchase requisition in parity with receiving reports?
2. Were the competitive bidding procedures followed?
3. Are the receiving reports initialed and signed properly?
4. Is the merchandise reported in supplier's invoice and receiving report, the same?
5. Are the copies of requisition, purchase order, invoice and receiving report in order and complete?
6. Whether the principles of buying i.e. right price, quantity, quality etc. are adhered to or not?
7. Whether the terms in the purchase requisition tally with the materials specifications, quality required and delivery schedule?
8. Whether a master list of suppliers in maintained with u dations, if any?
9. Whether proper coordination exists between initiating department and purchase department in the matter of floating enquiries?
10. Whether telephonic/electronically quotations are received and the value involved is large?
11. Whether any purchase requisition is pending for long?
12. Whether follow up for delivery is done?
13. Whether the operations are in sync are with those in purchase manual?
14. Whether management directives adhered to?
15. How purchase records are maintained?
16. How the stock ledgers and records maintained?
17. Whether the transactions are in parity with purchase budget and cost control budget?
18. Whether any purchase committee report exists?
19. Whether the purchase department maintains a "purchase value analysis programme" to ascertain how efficiently and effectively buying is done?
20. Whether statutory laws and rules including Schedule VI to the Companies Act and are complied with CARO, 2003 etc.
21. Whether the management directives with respect to purchases are properly adhered to?

(Illustrative)

ICPAP

i. Pursuant to Rule 5 of the Cost Audit (Report) Rules, 2001, the report of the Cost Auditor shall be forwarded to the Central Government and to the concerned company within one hundred and eighty days from the close of the company's financial year to witch the report relates. In the present case, the report should have been presented within one hundred and eighty days from 31st March 2005 i.e. or on before 27th September 2005. (Rule 5). But it was presented on 25th October 2005. Consequently, the cost auditor becomes liable (under Rule 8), with fine which may extend to five thousand rupees. However, the actual default seems to be on the part of the company and every officer thereof which should have furnished such cost accounting records etc, to the cost auditor within one hundred and thirty five days from 31st March 2005 (i.e. 13th August 2005) as would have been required for conducting cost audit (Rule 6). Also, the necessary assistance should have been rendered to the cost auditor so as to enable him to complete the cost audit and submit his report within the time limit specified in Rule 5. As the company has contravened the provisions of Rule 6, it shall be liable under Rule 8 or Cost Audit (Report) Rules, 2001.

ii. As per Rule 4(2) of the Cost Audit (Report) Rules, 2001 the Cost Auditor shall give the clarifications required by the Central Government within 30 days of the receipt of the communication seeking clarification.
In the present case the communication seeking clarification was received on 16.10.2004. Therefore, the same were to be furnished by 15.11.2004 i.e. 30 days excluding the date of receipt.
However, the Cost Auditor furnished the clarifications on 10.12.2004 on the 55th day excluding the data of receipt of the communication. He is liable for punishment with fine which may extend to Rs. 5000, (Rule 8).

iii. Rule 7 of the Cost Audit (Report) Rules, 2001 lays down that the Annexure and Proforma prescribed with the Cost Audit Report shall be approved by the Board of Directors before submitting the same to the Central Government by the Cost Auditor. The Annexure and Proforma duly audited by the Cost Auditor shall also be signed by the Company Secretary and at least one Director. In the absence of the Company Secretary, the same shall be signed by at least two Directors.
In the present case, there is no approval of the Annexure and Proforma by Board of Directors and authentication is done by MD only. This contravenes the provisions of Rule 7 and accordingly penal provisions of Rule 8 shall be attracted.

Question:-

a) As an information systems auditor, explain the concept of 'change management' relating to software life cycle. Also, explain the process of change management.

b) "Understanding the relationship between risk and control is important in information systems audit."

c) **State the technical skills required for conducting systems audit.**

d) **Indicate the information systems risks associated with internal controls that need scrutiny by information systems auditor.**

Answer:-

a) Most important aspect of Software Life Cycle is change. The change can be given by:

i. Internal Factors
ii. External Factors

There may be a change in Disclosures Format by SEBI. In such case organization has no choice, but to adopt a changed format.

Change can be driven due to internal factors, because of changes necessitated in internal control procedures and systems. For instance, there may be changes in tax laws such as change in Income Tax Law, Central Excise Laws, and Sales Tax etc. This necessitates making necessary changes in the database and other related programmes in the computer.

Change management process consists of:

i. Setting-up of Change Control Authority in the organization.
ii. Setting-up of Change initiation, Change Review and Change Authorization procedure.
iii. Implementation Procedure.
iv. Documentation Procedure.

The change control board should consist of functional heads, HOD of internal audit. The change initiation takes place when detailed written request is raised from the effected party department. The request is sent to the Co-ordinator of change control board. Finally after the deliberations the request may be routed to I.T. Department to find out whether they require extra financial resources for implementation.

The system auditor needs to look into the entire change control process lest the rigor with which the system was introduced can be diluted. There is high rate of obsolescence in I.T. the change control board also needs to take care of issues relating to technology renewal.

b) Understanding Risks Controls

Understanding the relationship between risk and control is important in I.S. the auditor must be able to identify different types of risks and the controls used vis-à-vis those required to mitigate these risks.

Risks that threaten the I.S. cannot be eliminated. They can be mitigated by appropriate security. This security is to be implemented within the framework of controls envisaged

by the management. I.S. auditor has to evaluate their adequacy and appropriateness to mitigate risk. Weaknesses that exist are to be reported by the I.S. Auditor to understand the process and procedure of reviewing and evaluating controls.

Threats can be outcome of poor control or no control. A threat is some action or event that can lead to a loss (a risk). "The potential that a given threat will exploit the vulnerabilities of an asset or group of assets to cause loss or damage to them" is considered as risk. The result of threat analysis is vulnerabilities. The risk of a threat exploiting a vulnerability leads to impact i.e., result of loss of any sort on account of risk. Exposure is the potential loss on account of the actualizing of the risk. Risk assessment identifies the elements of risk and combines them to give the overall view of the risk.

For example fire is a threat to a computer center. This is an inherent vulnerability which cannot be entirely eliminated but can be mitigated by e.g. prohibiting smoking, encasing all electrical wiring, having fire proof walls or fire proof cabinet for storing all the software and data, installing smoke detection system or fire extinguishers. These measures shall mitigate the risk of fire. Further, the company may obtain insurance for loss of assets/profits. This is called as risk transfer. The remaining risk termed residual risk has to be accepted by the management.

The loss due to fire is termed exposure. The impact of fire is the loss to the company due to disruption of business, loss of customers, loss of assets etc. while assessing risk the I.S. Auditor has to consider the various types of threats, vulnerabilities, risk exposure and the probability of their occurrence.

A common method used to quantify risk is as follows: calculate the impact against probability of each treat. e.g. if the loss on account of fire is Rs. 5 lakhs and the probability of its occurrence is 0.2% then the potential risk exposure would be: 5,00,000× 2/100 = Rs. 1,000.

If the expected loss is Rs. 20, 00,000 and the probability of occurrence is 2% then the exposure would be: 20, 00,000 × 2/100 = Rs. 40,000

Control assessment: After the risks have been identified, existing controls can be evaluated or new controls can be designed to ensure that the risk is maintained at the acceptable level.

At the time of evaluation is should be considered whether controls are preventive or detective, manual or programmed and formal.

c) The system Auditor is able to assess whether the control objectives are met or not. For instance Network Security is a major area which is highly technical. It covers Operating System, Database Management System, Network Detection and Devices such as Firewalls, Content Inspection and Intrusion Detection. Everyday new attack patterns are

discovered and remedial measures taken. The I.S. Auditor needs to know about these to be able to assess the risks for taking steps to overcome the problem. The risks may not have impact on a given organization, but the functional knowledge of I.S. Auditor will certainly help in this regard.

d) **Nature of Information System Risks related to internal controls**

Risks associated with internal control in a computerized environment include:

A. Lack of transaction trails:
B. Uniform processing of transaction:
C. Poor segregation of functions:
D. Potential for errors and irregularities:
E. Initiation or execution of transactions:
F. Dependence of other controls over computer processing:
G. Potential for increased management supervision:
H. Potential for the use of computer assisted audit techniques.

Question:-

You are the manager in-charge on the annual audit of Decimal World Limited (DWL) for the year ended December 31, 2009. DWL is a leading manufacturer of electrical appliances. 35% of its shares are held by Binary Pakistan Limited (BPL). However, with the help of some consenting shareholders, BPL has been able to nominate 5 out of 8 directors on the Board.

During the planning phase of the audit you became aware of the following matters:

a) A foreign investor has made a public offer to purchase 51% shares of DWL at a price of Rs. 13 per share. The share price has ranged between Rs. 12 to Rs. 14 per share during the past six months.
b) The company's statement of financial position includes a deferred tax asset of Rs. 30 million on account of unutilized tax losses which have accumulated during the loss making period 1999-2004. The management is of the view that future taxable profits would be sufficient to utilize the available tax losses.
c) DWL has established an e-commerce division to sell its products through internet. This new division is administered centrally by the head office. This step has been quite successful as the online sales have risen to 20% of the total sales during the year.

Required:

Identify and explain the audit risks which the auditor should consider while planning the audit of DWL. Also highlight the key areas on which the auditor should place emphasis upon, to address the above risks.

Answer:-

a) Audit risk: Pressure to maintain the earnings

i. The management of DWL is under pressure to maintain the earnings of the company in order to keep the share price of the company over Rs. 12.5 so that the offer of foreign investor will not attract the small investors.

ii. The areas requiring the auditors attention are as follows:
- Revenues are recorded correctly as to amount and period.
- Inventories are properly valued and recorded in the correct period.
- All expenses and provisions are recorded correctly as to amount and period.

b) Audit risk: Recoverability of deferred tax assets

i. Under IAS-12, deferred tax assets can only be recognized when it is probable that taxable profits will be available against which the deductible temporary differences can be utilized. The company will therefore need to show that future profits will be generated for the unutilized tax losses to be offset against. If this is not possible, the deferred tax asset should be limited to the amount of profits that can be measured with reasonable certainty.

ii. The main areas which require auditors attention are as follows:
- The income tax provisions related to carry forward of tax losses and their adjustment against future profits.
- Amount of future profits and reasonableness of such forecast.

c) Audit risk: Issues relating to e-commerce sales

i. Risk of non-compliance with taxation, legal and other regulatory issues

ii. Risk of technological failure resulting in business interruption

iii. Loss of transaction integrity

iv. Risk of frauds by customers and employees

v. Risk of application of improper accounting policies in respect of capitalization of costs such as website development, translation of foreign currencies, allowances for returns, revenue recognition. etc.

vi. The main areas which require auditors attention are as follows:
- The effect of e-commerce model on the existing accounting policies
- The adequacy of internal controls in place.
- Process alignment. It refers to the way various IT systems are integrated with one another and thus operate, in effect, as one system.
- Key security issues and how the management intends to address them
- Legal issues and opinion of the legal advisors.

Question:-

You are a chartered accountant in practice. The following situations have arisen in connection with two of your clients:

a) A multinational company (MNC) which is planning to establish a place of business in Pakistan by forming a public limited company under the Companies Ordinance, 1984, has requested your firm to provide the following services:
   i. Receive the funds remitted by the MNC.
   ii. Make disbursements in accordance with the instructions of the MNC.

Required:

Explain how you would meet your professional obligations and responsibilities while carrying out the above assignment.

b) Your firm is the external auditor of a listed company. Recently the management of the company has requested your firm to provide the following services:
   i. Reconciling the creditors' ledger with the statements submitted by the suppliers.
   ii. Estimating the compensation payable to the employees who were seriously injured while carrying out the trial run of the plant.

Required:

Explain the threats involved in accepting the above assignments and identify the steps the firm should take to fulfill its professional responsibilities and obligations.

Answer:-

(a) (i) While taking up the assignment, we should keep in mind the following:

- A chartered accountant in practice should not assume custody of client's monies unless permitted to do so by law.
- It creates a self-interest threat to professional behavior and may be a self-interest threat to objectivity.
- To safeguard against such threats, we would:
  - Keep such monies separately from firm's assets.
  - use such money only for the purpose for which they are intended;
  - at all times, be ready to account for these assets, and any income, dividends or gains generated, to any persons entitled to such accounting.
  - Comply with all relevant laws and regulations relevant to the holding of and accounting for such assets.

- We should be aware of threats to compliance with the fundamental principles through association of such assets. For example, money derived from illegal activities. In order to safeguard against these threats, we should:
    - make appropriate inquires about the source of such assets;
    - Consider their legal and regulatory obligations.
    - seek legal advice.

(ii) There is no bar to accepting this business as MNC is not our financial statements audit client.

(b) (i) Preparation of such reconciliations may be used by the client as base document of accounting entries. Therefore, it may create a self-review threat when the financial statements are subsequently audited by the firm.

- While providing such assistance, the auditor should not involve in making management decision which include:
    - Determining or changing journal entries, or the classifications for accounts or transaction or other accounting records.
    - Authorizing or approving transactions; and
    - Preparing source documents or originating data or making changes to such documents or data.
- The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:
    - Making arrangements so such services are not performed by a member of the assurance team;
    - Implementing policies and procedures to prohibit the individual providing such services from assisting in preparation of accounting records and making any managerial decisions on behalf of the audit client;

(ii) The estimation of compensation may be used by the client as a basis for making provisions in the accounts. Therefore, it may create a self-review threat. The significance of threat will depend upon the following factors:

- The materiality of the amounts involved;
- The degree of subjectivity inherent in the matter concerned; and
- The nature of the engagement i.e. the purpose and objective of estimation.

- The firm should evaluate the significance of threat and if it is significant then apply the necessary procedures to eliminate the threat or reduce it to an acceptable level. Such safeguards may include:
    - Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client.

- Using professional who are not members of the assurance team to perform the service;
- The involvement of others such as independent experts.

Question:-

You are the manager in charge on the audit of Hexa Garments Limited (HGL). The company is listed on the Karachi Stock Exchange and has nine directors. It is engaged in the manufacture and sale of fancy garments through its own retail outlets. You are considering the following matters in respect of the audit for the year ended December 31, 2009:

a) The diluted earnings per share of Rs. 36.60 has been calculated without taking into account the share options held by three directors. To justify the above calculations, these directors have confirmed in writing that they do not intend to exercise the share option. Had the share options been considered, the diluted earnings per share would have been Rs. 35.60. The review of subsequent events revealed that four of the remaining directors had exercised their share options following the balance sheet date.
The share options are available upto December 31, 2010.

b) According to the draft financial statements the total assets of the company are valued at Rs. 375 million. These include value of ten retail outlets amounting to Rs. 175 million. The valuation is based on historical cost less accumulated depreciation. During the year ended December 31, 2009, the management had decided to revalue all the retail outlets. The value appointed by the management has not been able to complete the assignment to date. However, he has submitted two interim reports as described below:

	Interim Report	
	First	**Second**
Date of report	31/12/09	20/02/10
Number of shops revalue	3	4
Book value as on 31/12/2009 (Rs. in million	40	60
Revalued amount (Rs. in million	70	100

c) During the year HGL has developed two new brands “Deebal” and “Kalachi” and has launched an aggressive marketing campaign for their promotion. The company has recognized the cost incurred on the campaign amounting to Rs. 10 million as an intangible asset. It is being written off over the estimated useful life of the brands i.e. four years.

Required:

Discuss the matters that may be of significance to you as an auditor, in respect of the above issues. Also explain their implications on the audit report.

Answer:-

a) **Matters significant to the Auditor**

   i. According to IAS-33, for the purpose of calculating diluted earnings per share, an entity shall assume the exercise of dilutive options of the entity. The IAS does not allow any exception to this rule.

   ii. Whether the share options given to the directors have been properly disclosed in the financial statements.

   iii. The exercise of share options after the close of year needs disclosure as a non-adjusting event.

   Implications on the audit report

   i. If the directors do not agree to amend the diluted earnings per share, the audit report should be modified in this respect on the ground of disagreement.

   ii. If proper disclosure relating to exercise of share option has not been made, the audit report should be modified due to non-disclosure of material information.

b) **Matters significant to the Auditor**

   i. According to IAS-16 Property, Plant and equipment, if an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

   ii. The increase due to revaluation of 7 of the 10 retail shops amounts to Rs. 70 million, which represents 18.67% of total assets and is therefore material to the statement of financial position. A disclosure will be required.

   iii. The auditor should ask the management either to defer the revaluation to a period when all information related to all the shops is available from the valuer or revalue all the shops by requesting the valuer to submit his final report prior to audit completion.

   Implication on the Audit Report:

   If the management refuses to disclose the information about the outcome of valuation exercise, the audit report should be modified on the ground of disagreement with qualified" opinion.

c) **Matters significance to the Auditor**

   i. According to IAS-38, internally generated brands shall not be recognized as intangible assets. Hence, the capitalization of internally generated brands is a contravention to the requirement of IAS-38.

   ii. The intangible asset is material as it represents 2.7% of total assets.

   Implications on the Auditor's Report

   If the financial statements are not revised in accordance with IAS, the audit report should be qualified on the ground of disagreement with qualified opinion due to material misstatement.

Question:-

You are the quality control partner in a medium size audit firm and have been asked to give your views on the following situations:

a) Pentagon Limited, an unlisted assurance client, has requested your firm to assist them in the recruitment of the Chief Financial Officer (CFO) of the company. While short listing the candidates, it was found that the applicants include CFOs of two of your existing assurance clients.

b) One of your firm's large clients, a listed company, has requested that the current year's audit should be carried out by the same team which audited the last year's financial statements. The request has been justified on the grounds that the accounts department is extremely busy on a special assignment and a new team would take a lot of their time. You have also been informed that Mr. Shams has been the manager in charge of that audit during the last three years.

Required:

Discuss the category of threat involved in each of the above situations. Also explain the safeguards available with the firm which may eliminate or reduce the threat to an acceptable level.

Answer:-

(a)

i. Recruitment of senior management may create current or future self-interest, familiarity and intimidation threats.

ii. Applications from CFOs of existing assurance clients has also created a threat to objectivity, as we performs services for these clients whose interests will be in conflict with Pentagon in respect of appointment of CFO.

iii. The significance of the threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level.

iv. The safeguards available to the engagement partner are the following:

- The firm should not make management decisions and engagement should be restricted to advising suitable qualification and making a list of suitable candidates. The decision as to whom to hire should be left to the client.
- The use of separate engagement team
- Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing);
- Clear guidelines for members of the engagement team on issues of security and confidentiality.

(b) Client's request for certain staffs

The audit firm should assess whether the reason given by the client is valid under the circumstances because if there is any other reason, it may affect the independence of the audit. Moreover, as a matter of principle, the audit firm should not encourage such requests from the client.

Long association of Mr. Shams

i. Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat.
ii. The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level.
Such safeguards might include:
    - Rotating the senior personnel (other than the audit team)
    - Involving an additional chartered accountant who was not a member of the assurance team to review the work done by the senior personnel or otherwise advise as necessary;
    - Independent internal quality reviews.

The Role of the Auditor in the Economy

Summary:-

This chapter explored the nature of the attest function, independent audits, and the auditing profession. To summarize:

1. A primary reason for the development of the public accounting profession is the attest function. When CPAs attest to information they issue a report with a conclusion about the reliability of a written assertion by management. In the case of financial statement audits, the audit report most frequently includes an opinion about whether management's financial statements conform to generally accepted accounting principles.
2. CPAs perform three different types of attestation engagements, including examinations, reviews, and agreed-upon procedures. When financial statements are examined, the engagement is called an audit.
3. Since audits involve examinations of financial information by independent experts, they increase the credibility of the information contained in the statements. Decision makers both within and outside the organization can use audited financial information with confidence that it is not likely to be materially misstated. Audits reduce information risk and, therefore, they reduce the overall risk of making various types of economic decisions.
4. The nature and emphasis of auditing has changed over the years. Auditing began with the objective of detecting fraud by examination of all, or most, business transactions. Today the objective of an audit is to attest to the fairness of the financial statements. Because of the large size of business organizations, audits necessarily involve the use of sampling techniques based on the auditors' consideration of the organization's internal controls. Auditors also are being asked to assume more responsibility for attesting to compliance with laws and regulations, and to the effectiveness of internal controls.
5. The auditing profession is much broader than auditors involved in public accounting; it also includes internal auditors and various governmental auditors, such as auditors of the General Accounting Office and the Internal Revenue Service.
6. Various professional and regulatory organizations have a significant influence on the auditing profession, including the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the Securities and Exchange Commission, and the Institute of Internal Auditors.
7. In addition to performing attestation engagements, CPA firms offer tax services, consulting services, and accounting and review services. CPA firms range in size from sole practitioners to the large international firms referred to as the "Big 6" firms. The professional staff of a typical medium-to-large CPA firm includes partners, managers, senior accountants, and staff assistants.

Key Terms

Agreed-upon procedures engagement An attest engagement in which the CPAs agree to perform procedures for a specified party and issue a report that is restricted to use by that party.

American Institute of Certified Public Accountants (AICPA) The national professional organization of CPAs engaged in promoting high professional standards to ensure that CPAs serve the public interest.

Assertion A representation or declaration, typically made by the management of an entity.

Attest engagement An engagement in which a practitioner is engaged to express a conclusion about the reliability of an assertion that is the responsibility of another party (generally management).

Audit of financial statements An examination designed to provide the highest level of assurance that CPAs provide that the financial statements follow generally accepted accounting principles, or another acceptable basis of accounting.

Business risk The risk that a company will not be able to meet its financial obligations because of economic conditions or poor management decisions.

Certified public accountant A person licensed by the state to practice public accounting as a profession, based on having passed the Uniform CPA Examination and having met certain educational and experience requirements.

Compilation of financial statements Presenting in the form of financial statements information that is the representation of management without undertaking to express any assurance on the statements.

Compliance audit An audit to measure the compliance of the organization with some established criteria; for example, laws and regulations.

CPA examination A uniform examination administered twice a year by the American Institute of Certified Public Accountants for state boards of accountancy to enable them to issue CPA licenses. The examination covers the topics of accounting and reporting, auditing, and professional responsibilities.

Examination An attest engagement designed to provide the highest level of assurance that CPAs provide on an assertion. An examination of financial statements is referred to as an audit.

Fraud Misrepresentation by a person of a material fact, known by that person to be untrue or made with reckless indifference as to whether the fact is true, with intent to deceive and with the result that another party is injured.

Generally accepted accounting principles (GAAP) Concepts or standards established by such authoritative bodies as the Accounting Principles Board (APB), the FASB, and the GASB and accepted by the accounting profession as essential to proper financial reporting.

Information risk The risk that the information used to assess business risk is not accurate. Auditing can directly reduce information risk, but not business risk.

Operational audit An analysis of a department or other unit of a business or governmental organization to measure the effectiveness and efficiency of operations.

Review An engagement designed to lend only a limited degree of assurance relating to an assertion. ~~As discussed in further detail in Chapter 19~~, the procedures performed are generally limited to inquiries and analytical procedures.

Securities and Exchange Commission (SEC) A government agency authorized to regulate companies seeking approval to issue securities for sale to the public.

Statements on Auditing Standards (SASs) A series of statements issued by the Auditing Standards Board of the AICPA. These statements are considered to be interpretations of generally accepted auditing standards.

Questions:-

Select the best answer for each of the following items and give reason for your choice.

a) Which of the following has primary responsibility for the fairness of the representations made in financial statements?
    1) Client's management
    2) Independent auditor.
    3) Audit committee.
    4) AICPA.

b) The most important benefit of having an annual audit by a CPA firm is to:
    1) Provide assurance to investors and other outsiders that the financial statements are dependable.
    2) Enable officers and directors to avoid personal responsibility for any misstatements in the financial statements.
    3) Meet the requirements of government agencies.
    4) Provide assurance that illegal acts, if any exist, will be brought to light.

c) Government auditing, in addition to including audits of financial statements, often includes audits of efficiency, effectiveness, and:
    1) Adequacy.
    2) Evaluation
    3) Accuracy.
    4) Compliance

d) Operational audits often have an objective of determining whether an entity's:
    1) Internal control structure is adequately operating as designed.
    2) Operational information is in accordance with generally accepted governmental auditing standards.
    3) Financial statements present fairly the results of operations.
    4) Specific operating units are functioning efficiently and effectively.

Professional Standards

This chapter described the nature of the generally accepted auditing standards, the attestation standards, and quality control standards. To summarize:

1. The 10 generally accepted auditing standards were adopted by the profession to provide a measure of quality for audits. The standards are divided into three types: general standards, standards of field work, and standards of reporting. All

audits must be performed in accordance with generally accepted auditing standards.

2. An audit provides reasonable assurance of detecting material misstatements of the financial statements (both errors and irregularities) and illegal acts that have a direct and material effect on the determination of financial statement amounts. Although an audit does not provide reasonable assurance of detecting illegal acts that have only an indirect effect on the financial statements, the auditors remain alert for such acts. If illegal acts are discovered, regardless of their type, the auditors must carefully evaluate their effects on the financial statements.
3. The attestation standards were adopted to provide a general framework for the attest function, and to set boundaries for these types of engagements. Similar to the generally accepted auditing standards, the 11 attestation standards are structured as general standards, standards of field work, and standards of reporting.
4. CPA firms establish quality control systems to ensure that all professional engagements are performed in accordance with applicable professional standards. The AICPA's Quality Control Standards provide guidance in developing these systems. To ensure that their quality control systems are adequate and operating effectively, CPA firms may arrange to have their practices peer reviewed by other CPAs. Obtaining periodic peer reviews is a requirement for membership in the AICPA.
5. Future auditing standards are expected to be developed on an international basis. Currently, the International Auditing Practices Committee issues pronouncements designed to foster the development of consistent worldwide auditing standards.

◆ Key Terms

Adequate disclosure All essential information as required by generally accepted accounting principles (or some other appropriate basis of accounting) is included in the financial statements.

Adverse opinion An opinion issued by the auditors that the financial statements they have audited *do not present fairly* the financial position, results of operation, or cash flows in conformity with generally accepted accounting principles.

Auditors' standard report A very precise document designed to communicate exactly the character and limitations of the responsibility being assumed by the auditors; in standard form, the report consists of an introductory paragraph, a scope paragraph, and an opinion paragraph.

Consistency The concept of using the same accounting principles from year to year so that the successive financial statements issued by a business entity will be comparable.

Disclaimer of opinion A form of report in which the auditors state that they do not express an opinion on the financial statements; it should include a separate paragraph stating the auditors' reasons for disclaiming an opinion and also disclosing any reservations they may have concerning the financial statements.

Division for CPA Firms A division of the AICPA providing a mechanism to regulate CPA firms. Firms may voluntarily join either or both sections: the SEC Practice Section and the Private Companies Practice Section.

Error An unintentional misstatement of financial statements or omission of an amount or a disclosure.

Generally accepted auditing standards (GAAS) A set of 10 standards adopted by the AICPA and binding on its members—designed to ensure the quality of the auditors' work.

Illegal Acts Violations of laws or governmental regulations.

Independence A most important auditing standard, which prohibits CPAs from expressing an opinion on financial statements of an enterprise unless they are independent with respect to such enterprise; independence is impaired by a direct financial interest, service as an officer or trustee, certain loans to or from the enterprise, and various other relationships.

Internal control structure A company's policies and procedures that are established to provide reasonable assurance that the company's objectives will be achieved. Such objectives include: (1) safeguarding its resources from waste, fraud and inefficiency; (2) promoting accuracy and reliability in accounting and operating data; (3) encouraging compliance with company policy; and (4) judging the efficiency of operations in all divisions of the business.

International Auditing Practices Committee (IAPC) A committee of the International Federation of Accountants, established to issue standards on auditing and reporting practices to improve the degree of uniformity of auditing practices and related services throughout the world.

International Federation of Accountants A worldwide organization of national accounting bodies to help foster a coordinated worldwide accounting profession with harmonized standards.

Irregularity An intentional misstatement of financial statements or omission of an amount or a disclosure.

Peer review The study and evaluation of a CPA firm's quality control policies and procedures by another CPA firm or a team of qualified CPAs.

Public Oversight Board An independent group of prominent nonaccountants who monitor the activities of the SEC Practice Section to provide assurance that the section is serving the public's interest.

Qualified opinion The appropriate form of audit report when there is a limitation in the scope of the audit or when the financial statements depart from GAAP significantly enough to require mention in the auditors' report, but not so materially as to necessitate disclaiming an opinion or expressing an adverse opinion.

Quality control standards Standards for establishing quality control policies and procedures that provide reasonable assurance that all of a CPA firm's engagements are conducted in accordance with applicable professional standards.

Unqualified opinion The form of audit report issued when the examination was adequate in scope and the auditors believe that the financial statements present fairly the financial position, operating results, and cash flows in conformity with generally accepted accounting principles.

Questions:-

Select the best answer for each of the following items and give reason for your choice.

a) The three generally accepted auditing standards classified as standards of field work may be summarized as:
   1) The need to maintain an independence in mental attitude throughout the audit.

2) The criteria for audit planning and evidence-gathering.
3) The criteria for the content of the auditors' report on financial statements.
4) **The competence, independence, and professional care to be exerted while performing the audit.**

b) A basic objective of a CPA firm to provide professional services that conform with professional standards. Reasonable assurance of achieving the basic objective is provided through:
1) Compliance with generally accepted reporting standards.
2) A system of quality control.
3) **A system of peer review.**
4) Continuing professional education.

c) Which of the following is not explicitly included in an unqualified standard audit report?
1) The CPA's opinion that the financial statements comply with generally accepted accounting principles.
2) That generally accepted auditing standards were followed during the audit.
3) That the internal control structure of the client was satisfactory.
4) **The subjects of the audit.**

d) The general group of the generally accepted auditing standards requires that:
1) The auditors maintain an independent mental attitude.
2) **The audit be conducted in conformity with generally accepted accounting principles.**
3) Assistants, if any, be properly supervised.
4) The auditor obtain an understanding of the internal control structure.

e) Which quality control standard would most likely be satisfied when a CPA firm maintains records indicating which partners or employees of the firm were previously employed by the records indicating which partners or employees of the firm were previously employed by the CPA firm's client?
1) Professional relationship.
2) **Supervision.**
3) Independence.
4) Advancement.

f) An "external peer review" is most likely to be performed by:
1) Employees and partners of the firm who are not associated with the audits being reviewed.
2) Audit review staff of the Securities and Exchange Commission.

3) Audit review staff of the Institute of Certified Public Accountants of Pakistan
4) **Employees and partners of another CPA firm.**

Professional Ethics

SUMMARY

This chapter explained the need for professionals to adhere to high standards of professional conduct, and described the details of the codes of ethics that apply to both external and internal auditors. To summarize:

1. Among the characteristics common to recognized professions are *(a)* acknowledgment of a responsibility to serve the public, *(b)* existence of a complex body of knowledge, *(c)* standards of admission to the profession, and *(d)* a need for public confidence.
2. The membership of the AICPA has adopted a *Code of Professional Conduct*, consisting of two sections—Principles and Rules. In addition, the AICPA issues *Interpretations* and *Ethics Rulings* to provide further guidance on appropriate ethical conduct.
3. Independence is required when CPAs perform audits and other types of attest engagements. Interpretation 101–1 provides guidance on various financial and business relationships that may impair a CPA's independence. That standard prohibits all direct financial interests in a client, as well as material indirect financial interests. The independence standards apply to all partners, all managerial employees assigned to an office that significantly participates in an engagement, and all professional staff personally participating in the engagement.
4. The Rules of the AICPA *Code of Professional Conduct* set forth the professional standards that must be followed by CPAs when performing various types of professional services. For example, Rule 202 requires auditors to adhere to generally accepted auditing standards, as interpreted by *Statements on Auditing Standards*. Accounting standards of the FASB and the GASB are enforced by Rule 203.
5. In performing an audit, the auditors have access to the details of the client's most confidential information. If the auditors disclosed this information, they might damage their clients' businesses. Therefore, CPAs are required to maintain a strict confidentiality relationship with their clients.
6. CPAs generally may accept engagements for contingent fees and receive commissions for referrals, but only if they do not also provide certain attestation or compilation services for the client.
7. A CPA firm may practice public accounting in any form of organization permitted by state law or regulation, including as a sole practitioner, partnership, professional corporation, or limited liability company.

8. The *Code of Ethics* of the Institute of Internal Auditors primarily addresses internal auditors' obligations to their employers, but it also includes provisions requiring honesty, objectivity, competence, and morality in the practice of internal auditing.

◆ KEY TERMS

Audit committee A committee of a corporation's board of directors that engages independent auditors, reviews audit findings, monitors activities of the internal auditing staff, and intervenes in any disputes between management and the independent auditors. Preferably, members of the audit committee are outside directors, that is, members of the board of directors who do not also serve as corporate officers.

Audit-sensitive position A position in which the activities are normally an element of, or subject to, significant internal controls. Examples include cashier, internal auditor, general accounting clerk, purchasing agent, or inventory warehouse supervisor.

Direct financial interest A personal investment under the direct control of the investor. The *Code of Professional Conduct* prohibits CPAs from having any direct financial interests in their audit clients. Investments made by a CPA's spouse or dependent child also are regarded as direct financial interests of the CPA.

Ethics Rulings Pronouncements of the AICPA that explain the application of Rules and Interpretations of the *Code of Professional Conduct* to specific factual circumstances involving professional ethics.

Independence A most important Rule of Conduct that prohibits CPAs from performing attestation services for an enterprise unless they are independent with respect to such enterprise; independence is impaired by a financial interest, service as an officer or trustee, loans to or from the enterprise, and various other relationships.

Indirect financial interest An investment in which the specific investment decisions are not under the direct control of the investor. An example is an investment in a professionally managed mutual fund. The *Code of Professional Conduct* allows CPAs to have indirect financial interests in audit clients, as long as the investment is not material in relation to the CPA's net worth.

Interpretations of Rules Guidelines issued by the AICPA for the scope and application of the Rules of Conduct.

Managerial employee A professional employee who either has a position generally similar to that of a partner or has a management position. Loosely translated, the term refers to professional staff at the rank of "manager" or above.

Principles of the Code The part of the AICPA *Code of Professional Conduct* that expresses the profession's responsibilities to the public, clients, and colleagues, and provides a framework for the Rules.

Profession An activity that involves a responsibility to serve the public, has a complex body of knowledge, has standards for admission, and has a need for public confidence.

Prospective financial information Presentations of future financial position, results of operations, or cash flows. Such presentations are often referred to as financial forecasts or projections.

Rules A group of enforceable ethical standards included in the AICPA *Code of Professional Conduct.*

Significant influence (over the operating, financial, or accounting policies of an entity) Examples of positions that are able to exert significant influence include serving as an executive, operating, financial or accounting officer, as a board of directors member, or as an underwriter for the client.

Audit Evidence:-

CHAPTER SUMMARY

This chapter focuses on the concept of sufficient competent evidential matter. To summarize:

1. The third standard of field work requires the auditors to obtain sufficient competent evidential matter to support their audit opinion. To be competent, evidence must be both relevant and valid. In general, evidence is considered more valid when it is *(a)* obtained from independent sources outside of the client organization, *(b)* generated from an accounting system that has effective internal controls, or *(c)* obtained directly by the auditors, rather than from a secondary source. The auditors use professional judgment to determine the amount of evidence that is sufficient to support their opinion.
2. Evidence is gathered by the auditors to reduce audit risk, which is the risk of failing to modify their opinion on financial statements that are materially misstated. Since financial statements consist of a series of assertions by management, the auditors must obtain sufficient competent evidential matter about each material financial statement assertion.
3. At the individual account balance level, audit risk consists of (1) the risk that a material misstatement in an assertion has occurred (composed of inherent risk and control risk), and (2) the risk that the auditors do not detect the misstatement (detection risk). Audit evidence is gathered by the auditors to assess both inherent and control risk, and to restrict detection risk.
4. Auditors must be especially careful in considering financial statement accounts that are affected by estimates made by management, such as the allowance for doubtful accounts. The inherent risk of these types of accounts is generally much greater than for other financial statement accounts.

KEY TERMS

Audit risk The risk that the auditors may unknowingly fail to appropriately modify their opinion on financial statements that are materially misstated.

Competence The competence of evidential matter relates to its quality. To be competent, evidence must be both valid and relevant.

Control risk The risk that a material misstatement that could occur in an account will not be prevented or detected on a timely basis by internal control.

Cutoff The process of determining that transactions occurring near the balance sheet date are assigned to the proper accounting period.

Detection risk The risk that the auditors' procedures will lead them to conclude that a financial statement assertion is not materially misstated, when in fact such misstatement does exist.

Evidential matter Any information that corroborates or refutes the auditors' premise that the financial statements present fairly the client's financial position and operating results.

Inherent risk The risk of material misstatement of a financial statement assertion, assuming there were no related internal controls.

Material Of substantial importance. Significant enough to affect evaluations or decisions by users of financial statements. Information that should be disclosed in order that financial statements constitute a fair presentation. Involves both qualitative and quantitative considerations.

Related party transaction A transaction in which one party has the ability to influence significantly the management or operating policies of the other party, to the extent that one of the transacting parties might be prevented from pursuing fully its own separate interests.

Representation letter A single letter or separate letters prepared by officers of the client company at the auditors' request setting forth certain representations about the company's financial position or operations.

Specialist A person or firm possessing special skill or knowledge in a field other than accounting or auditing, such as an actuary.

Substantive tests Tests of account balances and transactions designed to detect any material misstatements in the financial statements.

Sufficient Sufficient evidential matter is a measure of the quantity of the evidence.

Questions:-

Select the best answer for each of the following items and give reason for your choice.

a) As part of their audit, CPAs obtain a representation letter from their client. Which of the following is not a valid purpose of such a letter?
   1) To increase the efficiency of the audit by eliminating the need for other audit procedures.
   2) To remind the client's management of its primary responsibility for the financial statements.
   3) To document in the audit working papers the client's responses to certain verbal inquires made by the auditors during the engagement.
   4) To provide evidence in those areas dependent upon management's future intentions.

b) Which of the following statements best describes why auditors investigate related party transactions?
   1) Related party transactions generally are illegal acts.
   2) **The substance of related party transactions may differ from their form**.
   3) All related party transaction must be eliminated as a step in preparing consolidated financial statements.
   4) Related party transactions are a form of management fraud.

c) Of the following, which is the least persuasive type of audit evidence?
   1) Confirmations mailed by outsiders to the auditors.
   2) Correspondence between the auditors and suppliers.
   3) Copies of sales invoices inspected by the auditors.
   4) Canceled checks returned in the year-end bank statement directly to the client.

d) Analytical procedures are most likely to detect:
   1) Weakness of a material nature in internal control.
   2) Unusual transactions.
   3) Noncompliance with prescribed control procedures.
   4) Improper separation of accounting and other financial duties.

e) If the auditors unknowingly understate control risk, which of the following is most likely to also be understated?
   1) Audit risk.
   2) Business risk.
   3) Inherent risk

4) Detection risk.

f) Which of the following is least likely to indicate high inherent risk in an account?
   1) The account was misstated in the prior year audit.
   2) The company has maintained a 4 – 6 percent increase in profits during each of the past six years.
   3) Valuation of the account is affected by economic factors
   4) The company is in poor financial condition and may have a "going concern problem."

Planning the audit, designing audit programs

Chapter summary

This chapter explained the manner in which auditors plan an audit and design audit programs. To summarize:

1. Investigating a potential audit client is essential because auditors want to avoid accepting clients that have unscrupulous management. As a part of their investigation the auditors are required to communicate with the predecessor auditors. Arrangements for the engagement are set forth in the engagement letter, which makes clear the nature of the engagement, any limitations on the work, and the responsibilities of the client.
2. Once the client has been accepted, the auditors will perform procedures to obtain a more detailed understanding of the client's business and industry, and will develop an overall audit strategy which considers both materiality and audit risk.
3. When planning an audit the auditors are required to perform preliminary analytical procedures, which help them to obtain a better understanding of the nature of the client's business and identify accounts that have a higher risk of material misstatement.
4. The planning process is documented with audit plans, time budgets, and audit programs. Audit programs generally include both a systems portion that focuses on the client's internal control structure, and a substantive testing portion. The audit procedures that are contained in the audit program are designed around the assertions of management that are embodied in the financial statements.
5. Subsequent to planning, the audit process consists of considering and testing the client's internal control structure, performing substantive tests, forming an opinion on the financial statements, and issuing the audit report.

Key terms

Analytical procedures Tests that involve comparisons of financial data for the current year to that of prior years, budgets, nonfinancial data, or industry averages. From a planning standpoint, analytical procedures help the auditors obtain an understanding of the client's business, and identify financial statement amounts that appear to be affected by errors or irregularities, or other potential problems.

Audit committee A committee composed of outside directors (members of the board of directors who are neither officers nor employees) charged with responsibility for maintaining contact with the company's internal and independent auditors.

Audit plan A broad overview of an audit engagement prepared in the planning stage of the engagement. Audit plans usually include such matters as the objectives of the engagement, nature of the work to be performed, a time schedule for major audit work and completion of the engagement, and staffing requirements.

Audit program A detailed listing of the specific audit procedures to be performed in the course of an audit engagement. Audit programs provide a basis for assigning and scheduling audit work and for determining what work remains to be done. Audit programs are specially tailored to each engagement.

Audit risk The risk that the auditors may unknowingly fail to appropriately modify their opinion on financial statements that are materially misstated.

Business risk of the auditors The overall risk to the CPA firm of association with a particular audit client. The primary elements involved are the risk of loss of reputation and litigation if the client has financial difficulties.

Control risk The risk that a material misstatement that could occur in an account will not be prevented or detected on a timely basis by internal control.

Detection risk The risk that the auditors' procedures will lead them to conclude that a financial statement assertion is not materially misstated, when in fact such misstatement does exist.

Engagement letter A formal letter sent by the auditors to the client at the beginning of an engagement summarizing the nature of the engagement, any limitations on the scope of audit work, work to be done by the client's staff, and the basis for the audit fee. The purpose of engagement letters is to avoid misunderstandings, and they are essential on nonaudit engagements as well as audits.

Interim period The time interval from the beginning of audit work to the balance sheet date. Many audit procedures can be performed during the interim period to facilitate early issuance of the audit report.

Management assertions Representations of management that are communicated, explicitly or implicitly, by the financial statements.

Predecessor auditor The CPA firm that formerly served as auditor but has resigned from the engagement or has been notified that its services have been terminated.

Shopping for principles Conduct by some enterprises that discharge one independent auditing firm after seeking out another firm that will sanction a disputed financial statement principle or presentation.

Substantive approach (to an audit) An approach to auditing in which the auditors' opinion is based primarily upon the evidence obtained by substantiating the individual financial statement assertions. This approach places less emphasis upon the consideration of internal control than does the systems approach and is particularly appropriate when internal control is weak.

Substantive tests Tests of account balances and transactions designed to detect any material misstatements in the financial statements. The nature, timing, and extent of substantive testing are determined by the auditors' consideration of the client's internal control structure.

Successor auditor An auditor who has accepted an engagement or who has been invited to make a proposal for an engagement to replace the CPA firm that formerly served as auditors.

Systems approach (to an audit) An approach to auditing in which the auditors place a relatively high degree of reliance upon their consideration of the client's internal control and, therefore, perform a minimum of substantive testing. Whether an auditor follows a systems approach or a substantive approach is merely a matter of degree; every engagement involves both an assessment of control risk and substantive testing.

Time budget An estimate of the time required to perform each step in the audit.

Transaction cycle The sequence of procedures applied by the client in processing a particular type of recurring transaction. The term *cycle* reflects the idea that the same sequence of procedures is applied to each similar transaction. The auditors' consideration of internal control often is organized around the client's major transactions cycles.

Questions:-

Select the best answer for each of the following items and give reason for your choice.

a) The audit committee of a company should normally be made up of:
   1) Representatives from the client's management, investors, suppliers, and customers.
   2) The audit partner, the chief financial officer, the legal counsel, and at least one outsider.
   3) Representatives of the major equity interests, such as preferred and common stockholders.
   4) Members of the board of directors who are not officers or employees.

b) Which of the following should not normally be included in the engagement letter for an audit?
   1) A description of the responsibilities of client personnel to provide assistance.
   2) An indication of the amount of the audit fee.
   3) A description of the limitations of an audit.
   4) A listing of the client's branch officers selected for testing.

c) Appointing the independent auditors early will enable:
   1) A more through audit to be performed.
   2) A sufficient understanding of internal control to be obtained.
   3) Sufficient competent evidential matter to be obtained.
   4) A more efficient audit to be planned.

d) Which portion of an audit may not be completed before the balance sheet date?
    1) Tests of controls.
    2) Issuance of a management letter.
    3) Substantive testing.
    4) Assessment of control risk.

e) Which of the following should the auditors obtain from the predecessor auditor before accepting an audit engagement?
    1) Analysis of balance sheet accounts.
    2) Analysis of income statement accounts.
    3) All matters of continuing accounting significance.
    4) Facts that might bear on the integrity of management.

f) As one step in testing sales transactions, a CPA traces a random sample of sales journal entries to debits in the accounts receivable subsidiary ledger. This test provides evidence as to whether:
    1) Each recorded sale represents a bona fide transaction.
    2) All sales have been recorded in the sales journal.
    3) All debit entries in the accounts receivable subsidiary ledger and properly supported by sales journal entries.
    4) Recorded sales have been properly posted to customer accounts.

Internal control

Chapter summary

This chapter explained the meaning and significance of internal control, the major components of the client's internal control structure, and the manner in which auditors consider internal control. To summarize:

1. Internal control is a process, effected by the entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the categories of (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations.
2. The five components of the internal control structure include the control environment, risk assessment, the accounting information and communication system, control activities, and monitoring. The portion of internal control relevant to auditors is that which pertains to the entity's ability to prepare reliable financial statements.

3. The auditors' consideration of internal control is performed to obtain information necessary to plan the audit and assess control risk. An adequate understanding of the five components of the internal control structure must be documented on all audits. This documentation may be accomplished by use of internal control questionnaires, written narratives, and flowcharts.
4. The auditors assess control risk for each major financial statement assertion to determine the nature, timing, and extent of the substantive tests of that assertion. If the auditors assess control risk at less than the maximum, they must perform tests of controls to determine that the related internal controls are operating effectively. Tests of controls consist of inquiries of appropriate client personnel, inspection of documents and reports, observation of the application of accounting policies and procedures, and reperformance of policies and procedures.
5. Auditors are required to report all reportable conditions that they discover during the audit to the audit committee. A reportable condition is a significant deficiency in the design or operation of an internal control that could adversely affect the organization's ability to record, process, summarize, and report financial data.

Key Terms

Assessed level of control risk The level of control risk used by the auditors in determining the acceptable detection risk for a financial statement assertion and, accordingly, in deciding on the nature, timing, and extent of substantive testing.

Audit decision aids Standard checklists, forms, or computer programs that assist auditors in making audit decisions by ensuring that they consider all relevant information, or that aid them in weighting and combining the information to make a decision.

Control risk The possibility that a material error or irregularity in a financial statement assertion will not be prevented or detected by the client's internal control.

Fidelity bonds A form of insurance in which a bonding company agrees to reimburse an employer for losses attributable to theft or embezzlement by bonded employees.

Foreign Corrupt Practices Act Federal legislation prohibiting payments to foreign officials for the purpose of securing business. The act also requires all companies under SEC jurisdiction to maintain a system of internal control providing reasonable assurance that transactions are executed only with the knowledge and authorization of management.

Incompatible duties Assigned duties that put an individual in a position to both perpetrate and conceal errors or irregularities in the normal course of job performance.

Internal auditors Corporation employees who design and execute audit programs to test the effectiveness and efficiency of all aspects of internal control. The primary objective of internal auditors is to evaluate and improve the efficiency of the various operating units of an organization rather than to express an opinion as to the fairness of financial statements.

Internal control questionnaire One of several methods of describing an internal control structure in audit working papers. Questionnaires are usually designed so that "no" answers prominently identify weaknesses in internal control.

Internal control A process, effected by the entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the categories of (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations.

Internal control structure (system) The policies and procedures used by an entity to achieve internal control. An internal control structure is composed of the five components of the control environment, risk assessment, control activities, the accounting information and communication system, and monitoring.

Management letter A report to management containing the auditors' recommendations for correcting any deficiencies disclosed by the auditors' consideration of internal control. In addition to providing management with useful information, a management letter may also help limit the auditors' liability in the event a control weakness subsequently results in a loss by the client.

Material weakness in internal control A reportable condition (see definition) in which the control system design or the degree of compliance do not reduce to a relatively low level the risk that material errors or irregularities might occur and not be detected.

Operational audit A review of a department or other unit of a business to evaluate the effectiveness and efficiency of operations.

Organizational structure The division of authority, responsibility, and duties among members of an organization.

Planned assessed level of control risk The level of control risk the auditor uses in developing a preliminary audit strategy which includes an appropriate combination of tests of controls and substantive tests.

Reportable condition A matter coming to the auditors' attention that represents a significant deficiency in the design or operation of the control structure, which could adversely affect the organization's ability to record, process, summarize, and properly report financial data.

Systems flowchart A symbolic representation of a system or series of procedures with each procedure shown in sequence. Systems flowcharts are a widely used method of describing an internal control structure in audit working papers.

Tests of controls Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements of financial statement assertions.

Transaction cycle The sequence of procedures applied by the client in processing a particular type of recurring transaction. The auditors' working paper description of internal control often is organized around the client's major transaction cycles.

Walk-through of the system A test of the accuracy and completeness of the auditors' working paper description of internal control. A walk-through is performed by tracing several transactions through each step of the related transaction cycle, noting whether the sequence of procedures actually performed corresponds to that described in the audit working papers.

Written narrative of internal control A written summary of internal control for inclusion in audit working papers. Written narratives are more flexible than questionnaires, but by themselves are practical only for describing relatively small, simple systems.

Question Requiring Analysis

An auditor is required to obtain a sufficient understanding of each of the components of an entity's internal control structure to plan the audit of the entity's financial statements and to assess control risk for the assertions embodies in the account balance, transaction type, and disclosure components of the financial statements.

Required

a. For what purpose should an entity's internal control structure.
b. For what purposes should an auditor's understanding of the internal control structure elements be used in planning an audit?
c. Explain why an auditor might decide to assess control risk at the maximum level for one or more financial statements for one or more financial statement assertions.
d. What must an auditor has determined that controls have been placed in operation?

Internal auditing is a staff function found in virtually every large corporation. The internal audit function is also performed in many smaller companies as part-time activity of individuals who may or may not be called internal auditors. The difference between the audits by independent auditors and to work of internal auditors are more basic than is generally recognized.

Required:-

a. Briefly discuss the auditing work performed by the independent public accountant and the internal auditor with regard to:
    1) Auditing objectives.
    2) General nature of auditing work.
b. In conduction their audit, the independent auditors may consider the work of the internal auditors. Discuss briefly the reason for this consideration.

Audit Sampling

Chapter summary

This chapter presented the concepts and techniques used by auditors to perform audit sampling. To summarize:

1. Audit sampling is defined as applying an audit procedure to less than 100 percent of the items in a population to make some conclusion about that population.
2. Auditors may use statistical or nonstatistical sampling to perform tests of controls or substantive tests. Statistical sampling allows the auditors to measure and control sampling risk. Sampling risk is the risk that the auditors will make an incorrect conclusion from the sample results, because the sample is not representative of the population.
3. The major type of statistical sampling plan for tests of controls is attributes sampling, which can provide the auditors with an estimate of the extent of the deviations from a prescribed internal control policy or procedure.
4. The two aspects of sampling risk for tests of controls include the risk of assessing control risk too high, which relates to the efficiency of the audit, and the risk of assessing control risk too low, which is critical because it relates to the effectiveness of the audit.
5. The major factors that affect the required sample size for an attributes sample are the risk of assessing control risk too low, the tolerable deviation rate, and the expected deviation rate in the population.
6. The two aspects of sampling risk for substantive tests include the risk of incorrect rejection and the risk of incorrect acceptance. The risk of incorrect acceptance is the critical risk, because if the auditors accept a materially misstated account balance, they may issue an inappropriate audit opinion.
7. When a classical variables sampling plan is used, the required sample size is determined by the risk of incorrect acceptance, the risk of incorrect rejection, the amount of tolerable misstatement for the account, and the standard deviation of the items in the account.
8. Classical variables sampling methods include mean-per-unit estimation, ratio estimation, and difference estimation.
9. When evaluating the results of a classical variables sampling plan, the auditors compute an acceptance interval; if the client's book value falls within the interval, it is accepted as being materially correct. Otherwise, the auditors generally must perform additional testing to determine whether the client's balance is actually misstated or the sample was not representative.
10. Many CPA firms use structured approaches to nonstatistical sampling for substantive tests. Such approaches increase the consistency of sampling decisions by various staff members within the firms.

Key Terms

Allowance for sampling risk (ASR, precision) An interval around the sample results in which the true population characteristic is expected to lie.

Attributes sampling A sampling plan enabling the auditors to estimate the rate of deviation (occurrence) in a population.

Confidence level The complement of the risk of incorrect acceptance.

Deviation rate (occurrence rate, exception rate) A defined rate of departure from prescribed control procedures.

Difference estimation A sampling plan that uses the difference between the audited (correct) values and book values of items in a sample to calculate the estimated total audited value of the population. Difference estimation is used in lieu of ratio estimation when the differences are not nearly proportional to book values.

Discovery sampling A sampling plan for locating at least one deviation, providing that the deviation occurs in the population with a specified frequency.

Dual-purpose test A test designed to test an internal control procedure and to substantiate the dollar amount of an account using the same sample.

Effective audit An audit that achieves the planned degree of effectiveness in detecting any material misstatement in the client's financial statements.

Efficient audit An effective audit that is performed at the lowest possible cost.

Expected deviation rate An advance estimate of a deviation rate. This estimate is necessary for determining the required sample size in an attributes sampling plan.

Mean The average item value, computed by dividing total value by the number of items comprising total value.

Mean-per-unit estimation A classical variables sampling plan enabling the auditors to estimate the average dollar value (or other variable) of items in a population by determining the average value of items in a sample.

Nonsampling risk The aspects of audit risk not due to sampling. This risk normally relates to "human" rather than "statistical" errors.

Normal distribution A frequency distribution in which item values tend to congregate around the mean with no tendency for deviation toward one side rather than the other. A normal distribution is represented graphically by a bell-shaped curve.

Physical representation of the population The population from which the auditors sample. The physical representation of the population differs from the actual population when it does not include items that exist in the actual population. For example, the auditors sample from a trial balance of receivables which may or may not include all actual receivables.

Population The entire field of items from which a sample might be drawn.

Precision See allowance for sampling risk.

Projected misstatement An estimate of the most likely amount of monetary misstatement in a population.

Random selection Selecting items from a population in a manner in which every item has an equal chance of being included in the sample.

Ratio estimation A sampling plan that uses the ratio of audited (correct) values to book values of items in the sample to calculate the estimated total audited value of the population. Ratio estimation is used in lieu of difference estimation when the differences are nearly proportional to book values.

Reliability See confidence level.

Representative sample A sample possessing essentially the same characteristics as the population from which it was drawn.

Risk of assessing control risk too high This risk is the possibility that assessed level of control risk based on the sample is greater than the true operating effectiveness of the internal control procedure.

Risk of assessing control risk too low This most important risk is the possibility that the assessed level of control risk based on the sample is less than the true operating effectiveness of the internal control procedures.

Risk of incorrect acceptance The risk that sample results will indicate that a population is *not* materially misstated when, in fact, it is materially misstated.

Risk of incorrect rejection The risk that sample results will indicate that a population is materially misstated when, in fact, it is not.

Sampling error The difference between the actual rate or amount in the population and that of the sample. For example, if an actual (but unknown) deviation rate of 3 percent exists in the population, and the sample's deviation rate is 2 percent, the sampling error is 1 percent.

Sampling risk The risk that the auditors' conclusion based on a sample might be different from the conclusion they would reach if the test were applied to the entire population. For tests of controls, sampling risks include the risks of assessing control risk too high and too low; for substantive testing, sampling risks include the risks of incorrect acceptance and rejection.

Sequential sampling A sampling plan in which the sample is selected in stages, with the need for each subsequent stage being conditional on the results of the previous stage.

Standard deviation A measure of the variability or dispersion of item values within a population; in a normal distribution, 68.3 percent of all item values fall within ± 1 standard deviation of the mean, 95.4 percent fall within ± 2 standard deviations, and 99.7 percent fall within ± 3 standard deviations.

Stratification Dividing a population into two or more relatively homogeneous subgroups (strata). Stratification increases the efficiency of most sampling plans by reducing the variability of items in each stratum. The sample size necessary to evaluate the strata separately is often smaller than would be needed to evaluate the total population.

Systematic selection The technique of selecting a sample by drawing every *n*th item in the population, following one or more random starting points.

Tolerable deviation rate The maximum population rate of deviations from a prescribed control procedure that the auditor will tolerate without modifying the planned assessment of control risk.

Tolerable misstatement An estimate of the maximum monetary misstatement that may exist in an account balance without causing the financial statements to be materially misstated.

Variables sampling Sampling plans designed to estimate a numerical measurement of a population, such as a dollar value.

Voucher A document authorizing a cash disbursement. A voucher usually provides space for employees performing various approval functions to initial. The term *voucher* may also be applied to the group of supporting documents used as a basis for recording liabilities or for making cash disbursements.

Review questions

Question: Describe what is meant by a sequential sampling plan?

Question: In performing a test of controls for sales order approvals, the CPAs stipulate a tolerable deviation rate of 8 percent with a risk of assessing control risk too low of 5 percent. They anticipate a deviation rate of 2 percent.

Required:

a. What type of sampling plan should the auditors use for this test?
b. Using the appropriate table or formula from this chapter, compute the required sample size for the test.
c. Assume that the sample indicates four deviations. Man the CPAs conclude with a 5 percent risk of assessing control risk too low that the population deviation rate does not exceed the tolerable rate of 8 percent?

Question: The use of statistical sampling techniques in an audit of financial statements does not eliminate judgmental decisions.

Required:

a. Identify and explain four areas in which judgment may be exercised by CPAs in planning a statistical test of controls.
b. Assume that the auditors' sample shows an unacceptable deviation rate. Discuss the various actions that they may take based upon this finding.
c. A nonstratified sample of 80 accounts payable vouchers is to be selected from a population of 3,200. The vouchers are numbered consecutively from 1 to 3,200 and are listed, 40 to a page, in the voucher register. Describe four different techniques for selecting a random sample of vouchers for inspection.

Audit working papers, examination of the general records

Chapter summary

This chapter focuses on audit working papers and the examination of general records. To summarize:

1. Working papers are the connecting link between the client's accounting records and the auditors' report. They are the property of the auditors, and are designed to assist the auditors in coordinating and reviewing the audit work, to provide support for the audit report, document the auditors' compliance with generally accepted auditing standards, and facilitate future audits of the client.
2. The general categories of most working paper are: (1) audit administrative working papers; (2) working trial balance and lead schedules; (3) adjusting journal entries and reclassification entries; (4) supporting schedules, analyses, reconciliations, and computational working papers; and (5) corroborating documents. These working papers are usually maintained in either current files (for matters pertaining solely to the current year's audit) or permanent files (for matters affecting more than the current year such as copies of articles of incorporation).
3. Auditors examine a variety of general records of clients, including nonfinancial records, financial records and accounting records. Nonfinancial records such as the articles of incorporation, minutes of the board of directors and various contracts allow auditors to better understand the nature of various transactions and needed disclosures. Financial records such as tax returns, previous financial statements, and registration statements filed with the SEC provide important background knowledge related to the audit.
4. Accounting records include the general ledger and the general journal. Auditors test the general ledger by performing tests to determine that (1) account balances are mathematically correct, (2) entries in the ledger were posted from journal entries, and (3) journal entries were properly posted. Transactions are directionally tested both to and from the general ledger.
5. Entries recorded in the general journal are those for which special journals have not been provided. Accordingly, a variety of infrequently occurring transactions are normally included. Auditors (1) foot the column totals of the journal (2) voucher selected entries to original documents, (3) scan the journal for unusual entries, and (4) determine that entries have received proper approval of an officer.

Key Terms

Adjusting journal entry A journal entry drafted by the auditors to correct a misstatement discovered in the financial statements and accounting records.

Administrative working papers Working papers specifically designed to help the auditors in planning and administration of the engagement, such as audit programs, internal control questionnaires and flowcharts, time budgets, and engagement memoranda.

Analysis A working paper showing all changes in an asset, liability, equity, revenue, or expense account during the period covered by the audit.

Articles of incorporation That part of the application to the state for a corporate charter that includes detailed information concerning the financial structure and other details of the business.

Bylaws Rules adopted by the stockholders at the inception of a corporation to serve as general guidelines in the conduct of the business.

Corroborating documents Documents and memoranda included in the working papers that substantiate representations contained in the client's financial statements. These working papers include audit confirmations, lawyers' letters, copies of contracts, copies of minutes of directors' and stockholders' meetings, and letters of representations from the client's management.

Cutoff The process of determining that transactions occurring near the balance sheet date are assigned to the proper accounting period.

Journal voucher A serially numbered document describing the details of a single journal entry and bearing the signature of the officer who approved the entry.

Lead schedule A working paper with columnar headings similar to those in a working trial balance, set up to combine similar ledger accounts the total of which appears in the working trial balance as a single amount.

Minutes book A formal record of the issues discussed and actions taken in meetings of stockholders and of the board of directors.

Permanent file A file of working papers containing relatively unchanging data, such as copies of articles of incorporation and bylaws, copies of minutes of directors', stockholders', and committee meetings, and analyses of such ledger accounts as land and retained earnings.

Reclassification entry A working paper entry drafted by the auditors to assure fair presentation of the client's financial statements, such as an entry to transfer accounts receivable credit balances to the current liabilities section of the client's balance sheet. Since reclassification entries do not correct misstatements in the client company's accounting records, they are not posted to the client's ledger accounts.

Substantive tests Tests of account balances and transactions designed to detect any material misstatements in the financial statements.

Tick mark A symbol used in working papers by the auditor to indicate a specific step in the work performed. Whenever tick marks are used, they must be accompanied by a legend explaining their meaning.

Vouch To verify the accuracy and authenticity of entries in the accounting records by examining the original source documents supporting the entries.

Working papers Papers that document the evidence gathered by auditors to show the work they have done, the methods and procedures they have followed, and the conclusions they have developed in an audit of financial statements or other type of engagement.

Working trial balance A working paper that lists the balances of accounts in the general ledger for the current and the previous year and also provides columns for the auditors' adjustments and reclassifications and for the final amounts that will appear in the financial statements.

Question requiring analysis

Question: The preparation of working papers in an integral part of the CPAs audit of financial statements. On a recurring engagement the CPAs review the working papers from their prior audit while planning the current examination to determine the papers' usefulness for the current engagement.

Required:

a. .
   1) What are the purpose or function of audit working papers?
   2) What records of the auditors may be included in audit working papers?
b. What factor affect the auditors' judgement of the type and content of the working papers for a particular engagement?
c. To comply with generally accepted auditing standards, the auditor include certain evidence in their working papers, for example. "evidence that the engagement was planned and work of assistants was supervised and reviewed." What other evidence should the auditors include in audit working papers to comply with generally accepted auditing standards?

Question: "Working papers should contain facts and noting but facts," said student A. "Not at all," replied student B. "The audit working papers may also include expressions of opinion. Facts are not always available to settle all issues." "In my opinion," said student C, "a mixture of facts and opinions in the audit working papers would be most confusing if the papers were produced as a means of supporting the auditors' position when their report has been challenged." Evaluate the issues underlying these arguments.

Accounts Receivable, Notes Receivable, and Sales Transactions

Chapter summary

In this chapter we described the details of internal controls over receivables and sales, the auditors' consideration of these controls, and substantive tests of the receivables and sales accounts. To summarize:

1. The sales cycle includes the receiving of orders from customers, the delivery and billing of goods and services, and the recording and collection of accounts receivable. Effective internal control over sales transactions is best achieved by having separate departments responsible for preparing sales orders, approving credit, shipping

merchandise, billing customers, maintaining the accounts receivable subsidiary ledger, and authorizing adjustments to sales and accounts receivable.

2. The auditors' consideration of internal control over sales and cash receipts provides them with a basis for assessing control risk for the financial statement assertions about sales and receivable accounts. To assess control risk at less than the maximum for a particular assertion, the auditors must perform tests of the operating effectiveness of the controls. The auditors' assessment of control risk then is used to determine the nature, timing, and extent of the substantive tests of the sales and receivables.
3. The primary objectives for the auditors' substantive tests of sales and receivables are to *(a)* substantiate the existence of receivables, *(b)* establish the completeness of receivables and sales transactions, *(c)* determine that the client has rights to the recorded receivables, *(d)* establish the clerical accuracy of records and supporting schedules of receivables and sales, *(e)* determine that the valuation of receivables and sales is at appropriate net realizable values, and *(f)* establish that the presentation and disclosure of receivables and sales are appropriate.
4. The most time-consuming and critical audit procedures for receivables and sales are those designed to test the assertions of existence, occurrence, and valuation. Among the procedures designed to achieve these objectives is confirmation of accounts receivable, which is generally required in all audits. Acknowledgment of the debt provides evidence of existence of receivables and occurrence of sales, as well as the gross valuation of the amounts. An important part of obtaining evidence about the proper valuation of accounts receivable is the auditors' evaluation of the adequacy of the allowance for uncollectible accounts. Since this account is a management estimate, it is typically audited by a combination of inquiry of management, analytical procedures, and inspection of various documentation.

Key Terms

Aged trial balance A listing of individual customers' accounts classified by the number of days subsequent to billing, that is, age. Serves as a preliminary step in estimating the collectibility of accounts receivable.

Confirmation The process of obtaining evidence by written communication with the debtor or other party to a transaction.

Consignment A transfer of goods from the owner to another person who acts as the sales agent of the owner.

Interim audit work Those audit procedures that can be performed before the balance sheet date. The purpose is to facilitate earlier issuance of the audit report and to spread the auditors' work more uniformly over the year.

Negative confirmation A confirmation request addressed to the debtor requesting a reply only if the balance shown on the confirmation is incorrect.

Pledging of receivables To assign to a bank, factor, finance company, or other lender an exclusive claim against accounts receivable as security for a debt.

Positive confirmation A confirmation request sent to the debtor asking it to confirm directly to the auditors the accuracy of the dollar amount shown on the request. Calls for a reply regardless of whether the amount is correct or incorrect.

Question: Among specific procedures that contribute to good internal control over accounts receivable are.

a. The approval of uncollectible account write-offs and credit memoranda by an executive and
b. The sending of monthly statements to all customers. State three other procedures conducive to strong internal control.

Select the best answer for each of the following and explain fully the reason for your selection.

a. To determine that all sales have been recorded, the auditors would select a sample of transactions *from* the:
   (1) Shipping documents file.
   (2) Sales journal.
   (3) Accounts receivable subsidiary ledger.
   (4) Remittance advices.

b. Which of the following might be detected by an auditors' review of the client's sales cutoff?
   (1) Excessive goods returned for credit.
   (2) Unrecorded sales discounts.
   (3) Lapping of year-end accounts receivable.
   (4) Inflated sales for the year.

c. To test the existence assertion for recorded receivables, the auditors would select a sample *from* the:
   (1) Sales orders file.
   (2) Customer purchase orders.
   (3) Accounts receivable subsidiary ledger.
   (4) Shipping documents (bills of lading) file.

d. Which assertion relating to sales is most directly addressed when the auditors compare a sample of shipping documents to related sales invoices?
   (1) Existence or occurrence.
   (2) Completeness.
   (3) Rights and obligations.
   (4) Presentation and disclosure.

e. Cooper, CPA, is auditing the financial statements of a small rural municipality. The receivable balances represent residents' delinquent real estate taxes. The internal control structure at the municipality is weak. To determine the existence of the accounts receivable balances at the balance sheet date, Cooper would most likely:
   (1) Send positive confirmation requests.
   (2) Send negative confirmation requests.
   (3) Examine evidence of subsequent cash receipts.
   (4) Inspect the internal records such as copies of the tax invoices that were mailed to the residents.

f. Identify the control that is most likely to prevent the concealment of a cash shortage resulting from the improper write-off of a trade account receivable:
   (1) Write-offs must be approved by a responsible official after review of credit department recommendations and supporting evidence.
   (2) Write-offs must be approved by the accounts receivable department.
   (3) Write-offs must be authorized by the shipping department.
   (4) Write-offs must be supported by an aging schedule showing that only receivables overdue by several months have been written off.

Inventories and cost of goods sold

Summary

This chapter described details of the internal controls over inventories and cost of goods sold, the auditors' consideration of these controls, and substantive tests of inventories and costs of goods sold. To summarize:

1. The audit of inventories present the auditors with significant risk because: (1) they often represent a very substantial current asset, (2) numerous valuation methods are used for inventories, (3) the valuation of inventories directly affects the cost of goods sold account, and (4) the determination of inventory quality, condition, and value is inherently complex.
2. Effective internal control over inventories requires appropriate policies and procedures for purchasing, receiving and issuing supplies and materials, producing and shipping products, and cost accounting. A perpetual inventory system is also important.
3. The auditors' objectives in the audit of inventories and cost of goods sold are to: (1) consider relevant internal controls, (2) establish the existence of, and the client's rights to, inventories, (3) establish the completeness of inventories, (4) establish the clerical accuracy of records and supporting schedules, (5) determine that inventories and cost of goods sold are valued in accordance with GAAP, (6) determine that presentation and disclosures of inventory accounts are appropriate.
4. The auditors' understanding of the internal controls over inventories, purchases, and production will allow them to design appropriate substantive tests of inventory and cost of goods sold accounts.
5. In the audit of inventories, auditors are primarily concerned about the existence assertion, that is, the possibility of overstatement of year-end balances. Therefore, a primary substantive test for inventory accounts is observation of the client's physical inventory. Other substantive procedures include price tests of the valuation of inventory items, cutoff tests, analytical procedures, and tests of the financial statement presentation and disclosure.

Key Terms

Bill of lading A document issued by a common carrier acknowledging the receipt of goods and setting forth the provisions of the transportation agreement.

Consignment A transfer of goods from the owner to another person who acts as the sales agent of the owner.

Cost Accounting Standards Board A five-member board established by Congress to narrow the options in cost accounting that are available under generally accepted accounting principles. Companies having significant supply contracts with certain U.S. government agencies are subject to the cost accounting standards established by the board.

Job time tickets A document designed to accumulate the labor and machine time devoted to a particular production order.

Master production schedule A schedule that is used to plan overall production for a period of time. The schedule illustrates the gross production of each of the company's products.

Observation The auditors' evidence-gathering technique of viewing a client activity to obtain physical evidence of performance.

Periodic inventory system A method of accounting in which inventories are determined solely by means of a physical inventory at the end of the accounting period.

Perpetual inventory system A method of accounting for inventories in which controlling accounts and subsidiary ledgers are maintained to record receipts and issuances of goods, both in quantities and in dollar amounts. The accuracy of perpetual inventory records is tested periodically by physical inventories.

Select the best answer for each of the following and explain fully the reason for your selection.

a. Instead of taking a physical inventory count on the balance-sheet date the client may take physical counts prior to the year-end if internal control structure policies and procedures are adequate and:

(1) Computerized records of perpetual inventory are maintained.
(2) Inventory is slow-moving.
(3) Computer error reports are generated for missing prenumbered inventory tickets.
(4) Obsolete inventory items are segregated and excluded.

b. The auditor's analytical procedures will be facilitated if the client:

(1) Uses a standard cost system that produces variance reports.
(2) Segregates obsolete inventory before the physical inventory count.
(3) Corrects material weaknesses in internal control before the beginning of the audit.
(4) Reduces inventory balances to the lower of cost or market.

c. When perpetual inventory records are maintained in quantities and in dollars, and internal control over inventory is weak, the auditor would probably:

(1) Want the client to schedule the physical inventory count at the end of the year.
(2) Insist that the client perform physical counts of inventory items several times during the year.
(3) Increase the extent of tests for unrecorded liabilities at the end of the year.
(4) Have to disclaim an opinion on the income statement for that year.

d. Which of the following is the best audit procedure for the discovery of damaged merchandise in a client's ending inventory?

(1) Compare the physical quantities of slow-moving items with corresponding quantities of the prior year.
(2) Observe merchandise and raw materials during the client's physical inventory taking.
(3) Review the management's inventory representations letter for accuracy.
(4) Test overall fairness of inventory values by comparing the company's turnover ratio with the industry average.

e. McPherson Corp. does not make an annual physical count of year-end inventories, but instead makes weekly test counts on the basis of a statistical plan. During the year, Sam Mullins, CPA, observes such counts as she deems necessary and is able to satisfy herself as to the reliability of the client's procedures. In reporting on the results of her examination, Mullins:

(1) Can issue an unqualified opinion without disclosing that she did not observe year-end inventories.
(2) Must comment in the scope paragraph as to her inability to observe year-end inventories, but can nevertheless issue an unqualified opinion.
(3) Is required, if the inventories were material, to disclaim an opinion on the financial statements taken as a whole.
(4) Must, if the inventories were material, qualify her opinion.

Property, plant, and equipment: Depreciation and Depletion

Chapter Summary

In this chapter we presented the appropriate internal controls for property, plant, and equipment accounts, the auditors' consideration of these controls, and the substantive procedures for property, plant and equipment. To summarize:

1. The financial statement capital "property, plant, and equipment" includes tangible assets with a useful life of more than one year that are used in operations. In the audit of property, plant, and equipment, the auditors' primary objectives are to: (1) consider internal controls over these assets, (2) determine the existence of property, plant, and equipment, (3) establish the propriety of the valuation or allocation methods, including the reasonableness of the depreciation program, (4) establish the completeness of recorded property, plant, and equipment, and (5) evaluate the adequacy of presentation and disclosure for property, plant, and equipment.
2. Key internal controls over property, plant, and equipment should include proper authorization of acquisitions, adequate records for the various units of property, periodic physical inspection of property, and the use of serially numbered retirement work orders.
3. In the audit of property, plant, and equipment for a continuing client, the emphasis of the testing is on transactions that occurred during the year, as contrasted to an emphasis on ending balances. Depreciation expense is often tested by recomputation or through the use of analytical procedures.
4. The auditors objectives for the audit of natural resources and intangible assets are similar to those for property, plant, and equipment. Often in auditing the depletion of natural resources, the auditors must rely upon specialists to estimate the quantity and quality of the resource. The audit of intangible assets typically involves vouching the cost of the assets and evaluating and testing the allocation methods used by the client.

Key Terms

Capital expenditure An expenditure for property, plant, and equipment that is properly charged to an asset account.

Cruising The inspection of a tract of forestland for the purpose of estimating the total lumber yield.

Revenue expenditure An expenditure for property, plant, and equipment that is properly charged to an expense account.

Work order A serially numbered accounting document authorizing the acquisition of plant assets. A separate series of retirement work orders may be used to authorize the retirement or disposal of plant assets, and a third variety consists of documents authorizing repair or maintenance of plant assets.

Select the best answer for each of the questions below and explain fully the reason for your selection.

a. With respect to an internal control measure that will assure accountability for fixed asset retirements, management should implement an internal control structure that includes:
- (1) Continuous analysis of miscellaneous revenue to locate any cash proceeds from sale of plant assets.
- (2) Periodic inquiry of plant executives by internal auditors as to whether any plant assets have been retired.
- (3) Utilization of serially numbered retirement work orders.
- (4) Periodic observation of plant assets by the internal auditors.

b. The auditors may conclude that depreciation charges are insufficient by noting:
- (1) Insured values greatly in excess of book values.
- (2) Large amounts of fully depreciated assets.
- (3) Continuous trade-ins of relatively new assets.
- (4) Excessive recurring losses on assets retired.

c. Which of the following is an internal control weakness related to factory equipment?
- (1) Checks issued in payment of purchases of equipment are not signed by the controller.
- (2) All purchases of factory equipment are required to be made by the department in need of the equipment.
- (3) Factory equipment replacements are generally made when estimated useful lives, as indicated in depreciation schedules, have expired.
- (4) Proceeds from sales of fully depreciated equipment are credited to other income.

d. Which of the following accounts should be reviewed by the auditors to gain reasonable assurance that additions to property, plant, and equipment are *not* understated?
- (1) Depreciation.
- (2) Accounts payable.
- (3) Cash.
- (4) Repairs.

e. When there are numerous property and equipment transactions during the year, an auditor planning to assess control risk at the minimum level usually plans to obtain an understanding of the internal control structure and to perform:
- (1) Tests of controls and extensive tests of property and equipment balances at the end of the year.
- (2) Extensive tests of current year property and equipment transactions.
- (3) Tests of controls and limited tests of current year property and equipment transactions.
- (4) Analytical procedures for property and equipment balances at the end of the year.

f. To strengthen internal control over the custody of heavy mobile equipment, the client would most likely institute a policy requiring a periodic:
- (1) Increase in insurance coverage.
- (2) Inspection of equipment and reconciliation with accounting records.
- (3) Verification of liens, pledges, and collateralizations.
- (4) Accounting for work orders.

Accounts payable and other liabilities
Chapter Summary

This chapter explained the fundamental controls over accounts payable and purchase transactions. It also discussed the auditors' consideration of these internal controls, and the substantive procedures for accounts payable and purchases. To summarize:

1. Accounts payable are short-term obligations arising from the purchase of goods and services in the ordinary course of the business.
2. The purchases cycle includes initiating and authorizing purchases, ordering goods and services, and recording and paying accounts payable. Effective internal control over purchase transactions is best achieved by having separate departments responsible for purchasing, receiving, and accounting for the transactions. In this manner, payments are made only for those purchases that are properly authorized and received.
3. The auditors' principal objectives in the examination of accounts payable and purchases are to: (*a*) substantiate the existence of recorded accounts payable and the occurrence of purchase transactions, (*b*) establish the completeness of accounts payable and purchase transactions, (*c*) determine that the client has obligations to pay the recorded accounts payable, (*d*) establish the clerical accuracy of records and schedules, (*e*) determine the appropriate valuation of accounts payable, and (*f*) determine that the presentation and disclosure of accounts payable and purchases are appropriate.
4. In auditing accounts payable and other liabilities, it is important for the auditors to remember that an understatement of liabilities will exaggerate the financial strength of a company in the same way as an overstatement of assets. Therefore, the auditors' substantive procedures primarily focus on the objective of determining the completeness of recorded amounts. A number of these procedures involve inspecting documents related to transactions occurring during the subsequent period to determine whether these items should have been recorded as liabilities at year-end.
5. Accrued liabilities represent obligations payable for services received before the balance sheet date that will be paid in the subsequent period. Examples include accrued warranty liabilities, accrued payroll, and accrued pension liabilities. The substantive procedures to audit these liabilities generally include inspection of documents, recomputation, and analytical procedures.

Key Terms

Accrued liabilities (accrued expenses) Short-term obligations for services of a continuing nature that accumulate on a time basis. Examples include interest, taxes, rent, salaries, and pensions. Generally not evidenced by invoices or statements.

Confirmation Direct communication with vendors or suppliers to determine the amount of an account payable. Represents high-quality evidence because it is a document created outside the client organization and transmitted directly to the auditors.

Consignment A transfer of goods from the owner to another person who acts as the sales agent of the owner.

Subsequent period The time extending from the balance sheet date to the date of the auditors' report.

Trade accounts payable Current liabilities arising from the purchase of goods and services from trade creditors, generally evidenced by invoices or statements received from the creditors.

Vendor's statement A monthly statement prepared by a vendor (supplier) showing the beginning balance, charges during the month for goods or services, amounts collected, and ending balance. This externally created document should correspond (except for timing differences) with an account in the client's accounts payable subsidiary ledger.

Voucher A document authorizing a cash disbursement. A voucher usually provides space for employees performing various approval functions to initial. The term *voucher* may also be applied to the group of supporting documents used as a basis for recording liabilities or for making cash disbursements.

Voucher register A special journal used in a voucher system to record liabilities requiring cash payment in the near future. Every liability recorded in a voucher register corresponds to a voucher authorizing future payment.

Select the best answer for each of the following and explain the reason for your selection.

a. Which of the following procedures is *least* likely to be completed before the balance sheet date?
  (1) Confirmation of receivables.
  (2) Search for unrecorded liabilities.
  (3) Observation of inventory.
  (4) Review of internal accounting control over cash disbursements.

b. An audit of the balance in the accounts payable account is ordinarily *not* designed to:
  (1) Detect accounts payable that are substantially past due.
  (2) Verify that accounts payable were properly authorized.
  (3) Ascertain the reasonableness of recorded liabilities.
  (4) Determine that all existing liabilities at the balance sheet date have been recorded.

c. Which of the following is the *best* audit procedure for determining the existence of unrecorded liabilities?
  (1) Examine confirmation requests returned by creditors whose accounts appear on a subsidiary trial balance of accounts payable.
  (2) Examine unusual relationships between monthly accounts payable balances and recorded purchases.
  (3) Examine a sample of invoices a few days prior to and subsequent to year-end to ascertain whether they have been properly recorded.
  (4) Examine selected cash disbursements in the period subsequent to year-end.

d. Auditor confirmation of accounts payable balances at the balance sheet date may be *unnecessary* because:
(1) This is a duplication of cutoff tests.
(2) Accounts payable balances at the balance sheet date may ***not*** be paid before the audit is completed.
(3) Correspondence with the audit client's attorney will reveal all legal action by vendors for nonpayment.
(4) There is likely to be other reliable external evidence available to support the balances.

e. A client erroneously recorded a large purchase twice. Which of the following internal control measures would be most likely to detect this error in a timely and efficient manner?
(1) Footing the purchases journal.
(2) Reconciling vendors' monthly statements with subsidiary payable ledger accounts.
(3) Tracing totals from the purchases journal to the ledger accounts.
(4) Sending written quarterly confirmation to all vendors.

f. For effective internal control, the accounts payable department should compare the information on each vendor's invoice with the:
(1) Receiving report and the purchase order.
(2) Receiving report and the voucher.
(3) Vendor's packing slip and the purchase order.
(4) Vendor's packing slip and the voucher.

Debt and equity capital

Chapter Summary

The details of the audit of long-term debt and equity accounts were discussed in this chapter. The chapter includes a description of the internal controls for these types of accounts, and the audit procedures that the auditors use to substantiate long-term debt and equity accounts. To summarize:

1. The financing cycle involves the activities of the company that are designed to obtain capital funds. It typically involves the issuance and repayment of debt and equity, as well as payment of interest and dividends. A primary concern for both of these types of transactions is proper authorization by the appropriate official in the company or by the board of directors.

2. Control over the issuance of bonds by a company is enhanced when an independent trustee represents the interest of the bondholders. The responsibilities of the trustee include monitoring the company's compliance with the requirements of the bond agreement, and processing the payments of interest and principal to individual bondholders.
3. Capital stock transactions are best controlled by employing a registrar/transfer agent who monitors the issuance of the company's stock and handles transfers of shares between investors. In smaller companies capital stock is controlled through the maintenance of a stock certificate book and a stockholders ledger.
4. After the auditors obtain an understanding of the client's internal control structure policies and procedures for the financing cycle, they will often perform only limited tests of controls because of the limited number of transactions typically involved. It is usually more efficient to assess control risk at a high level and perform detailed substantive tests of transactions.
5. In the audit of interest-bearing debt, the auditors' primary substantive procedures will include vouching selected transactions occurring during the period, examining debt agreements, confirming balances and terms, and evaluating compliance with restrictive covenants.
6. The auditors' primary substantive procedures for equity transactions will typically include vouching the major equity transactions occurring during the period, confirming the number of shares outstanding with the registrar, and evaluating the company's compliance with stock option plan requirements and other restricting agreements.

KEY TERMS

Additional paid-in capital Capital contributed by stockholders in excess of the par or stated value of the shares issued.

Debenture bond An unsecured bond, dependent upon the general credit of the issuer.

Indenture The formal agreement between bondholders and the issuer as to the terms of the debt.

Sinking fund Cash or other assets set aside for the retirement of a debt.

Stock certificate book A book of serially numbered certificates with attached stubs. Each stub shows the corresponding certificate number and provides space for entering the number of shares represented by the certificate, name of the shareholder, and serial number of the certificate surrendered in exchange for the new one. Surrendered certificates are canceled and replaced in the certificate book.

Stock option plan A formal plan granting the right to buy a specified number of shares at a stipulated price during a specified time. Stock option plans are frequently used as a form of executive compensation. The terms of such plans should be disclosed in financial statements.

Stock registrar An institution charged with responsibility for avoiding overissuance of a corporation's stock. Every new certificate must be presented to the registrar for examination and registration before it is issued to a stockholder.

Stock transfer agent An institution responsible for maintaining detailed records of shareholders and handling transfers of stock ownership.

Stockholders ledger A record showing the number of shares owned by each stockholder. This is the basic record used for preparing dividend payments and other communications with shareholders.

Treasury stock Shares of its own stock acquired by a corporation for the purpose of being reissued at a later date.

Select the best answer choice for each of the following, and justify your selection in a brief statement.

a. The audit procedure of confirmation is *least* appropriate with respect to:
(1) The trustee of an issue of bonds payable.
(2) Holders of common stock.
(3) Holders of notes receivable.
(4) Holders of notes payable.

b. An auditor is most likely to trace treasury stock purchase transactions to the:
(1) Numbered stock certificates on hand.
(2) Articles of incorporation.
(3) Year's interest expense.
(4) Minutes of the audit committee.

c. In the audit of a manufacturing company of medium size, which of the following areas would you expect to require the least amount of audit time?
(1) Owners' equity.
(2) Revenue.
(3) Assets.
(4) Liabilities.

d. The auditors can best verify a client's bond sinking fund transactions and year-end balance by:
(1) Recomputation of interest expense, interest payable, and amortization of bond discount or premium.
(2) Confirmation with individual holders of retired bonds.
(3) Confirmation with the bond trustee.
(4) Examination and count of the bonds retired during the year.

e. The auditors' program for the examination of long-term debt should include steps that require the:
(1) Verification of the existence of the bondholders.
(2) Examination of copies of debt agreements.
(3) Inspection of the accounts payable subsidiary ledger.
(4) Investigation of credits to the bond interest income account.

f. All corporate capital stock transactions should ultimately be traced to the:
(1) Minutes of the board of directors.
(2) Cash receipts journal.
(3) Cash disbursements journal.
(4) Numbered stock certificates.

Auditing operations and completing the audit

Summary

This chapter explained auditing operations and the considerations and procedures involved in completing the audit. To summarize:

1. The analysis throughout the text has emphasized the need to consider revenue and expense accounts in conjunction with the audit of asset and liability accounts. However, vouching and other substantive procedures are generally necessary for revenue and expense accounts that are less directly associated with transaction cycles such as miscellaneous revenue and selling, general, and administrative expenses.

2. Substantive tests for payroll accounts address the overall reasonableness of payroll costs and the proper allocation of these costs to the functional areas of manufacturing, selling, and administration. In addition, tests must be performed on the allocation of manufacturing costs to work in process, finished goods, and cost of goods sold.

3. Because of their objectives, certain audit procedures cannot be completed before the end of the audit. These procedures include: *(a)* search for unrecorded liabilities, *(b)* review the minutes of meetings, *(c)* perform final analytical procedures, *(d)* perform procedures to identify loss contingencies, *(e)* perform the review for subsequent events, and *(f)* obtain the representation letter.
4. The auditors must perform audit procedures to determine that loss contingencies have been properly presented and disclosed in conformity with *FASB Statement No. 5.* To identify loss contingencies, auditors perform various procedures, such as reviewing minutes of directors' meetings, inquiring of the client's lawyer, reviewing correspondence with financial institutions and regulatory agencies, sending confirmations to financial institutions, and obtaining a representation letter from officers of the company.
5. Subsequent events may be classified into two broad categories: *(a)* those providing additional evidence about facts existing on or before the balance sheet date (which may require adjusting entries), and *(b)* those involving facts coming into existence after the balance sheet date (which may require note disclosures). Many of these subsequent events relate to loss contingencies, and the audit procedures involved are similar to those for auditing those items.
6. Another important part of completing the audit is the procedures performed to evaluate audit findings and review the audit work. In evaluating audit findings, the auditors accumulate known misstatements, projected misstatements, and other estimated misstatements to determine if the aggregate results of their procedures support the fairness of the financial statements.
7. Auditors also have certain postaudit responsibilities. When auditors find, subsequent to the issuance of their audit report, that the financial statements are materially misleading, they should take steps to prevent continued reliance on their report. In some cases this might involve notification of regulatory agencies.

KEY TERMS

Analytical procedures Evaluations of financial information made by a study of plausible relationships between financial and nonfinancial information.

Commitment A contractual obligation to carry out a transaction at specified terms in the future. Material commitments should be disclosed in the financial statements.

Conservatism An accounting doctrine for asset valuation in which the lower of two alternative acceptable asset valuations is chosen.

Contingent liability A possible liability, stemming from past events, that will be resolved as to existence and amount by some future event.

Disclosure checklist A list of specific disclosures required by the FASB, GASB, and the SEC that is used to evaluate the adequacy of the disclosures in a set of financial statements.

General risk contingency An element of the business environment that involves some risk of a future loss. Examples include the risk of accident, strike, price fluctuations, or natural catastrophe. General risk contingencies should not be disclosed in financial statements.

Lawyer's letter A letter of inquiry sent by auditors to a client's legal counsel requesting a description and evaluation of pending or threatened litigation, unasserted claims, and other loss contingencies.

Loss contingency A possible loss, stemming from past events, that will be resolved as to existence and amount by some future event. Loss contingencies should be disclosed in notes to the financial statements if there is a reasonable possibility that a loss has been incurred. When loss contingencies are considered probable and can be reasonably estimated, they should be accrued in the accounts.

Minutes book A formal record of the issues discussed and actions taken in meetings of stockholders and of the board of directors.

Representation letter A single letter or separate letters prepared by officers of the client company at the auditors' request setting forth certain representations about the company's financial position or operations.

S-1 review Procedures carried out by auditors at the client company's facilities on or as close as practicable to the effective date of a registration statement filed under the Securities Act of 1933.

Subsequent event An event occurring after the date of the balance sheet but prior to completion of the audit and issuance of the audit report.

Total likely misstatement in the financial statements Total misstatement in the financial statements that is estimated by the auditors based on the results of audit procedures. For example, the projected misstatement from an audit sample is an estimate of the likely misstatement in the audit population.

Unasserted claim A possible legal claim of which no potential claimant has exhibited an awareness.

Select the best answer for each of the following and give reasons for your choice:

a. Which of the following is the *best* way for the auditors to determine that every name on a company's payroll is that of a bona fide employee presently on the job?
 (1) Examine personnel records for accuracy and completeness.
 (2) Examine employees' names listed on payroll tax returns for agreement with payroll accounting records.
 (3) Make a surprise observation of the company's regular distribution of paychecks.
 (4) Visit the working areas and confirm with employees their badge or identification numbers.

b. As a result of analytical procedures, the independent auditors determine that the gross profit percentage has declined from 30 percent in the preceding year to 20 percent in the current year. The auditors should:
 (1) Express an opinion that is qualified due to the inability of the client company to continue as a going concern.
 (2) Evaluate management's performance in causing this decline.
 (3) Require note disclosure.
 (4) Consider the possibility of a misstatement in the financial statements.

c. An auditor accepted an engagement to audit the 19X8 financial statements of EFG Corporation and began the field work on September 30, 19X8. EFG gave the auditor the 19X8 financial statements on January 17, 19X9. The auditor completed the field work on February 10, 19X9, and delivered the report on February 16, 19X9. The client's representation letter normally would be dated:
(1) December 31, 19X8.
(2) January 17, 19X9.
(3) February 10, 19X9.
(4) February 16, 19X9.

d. Which of the following procedures is most likely to be included in the final review stage of an audit?
(1) Obtain an understanding of internal control.
(2) Confirmation of receivables.
(3) Observation of inventory.
(4) Perform analytical procedures.

e. Subsequent to the issuance of the auditor's report, the auditor became aware of facts existing at the report date that would have affected the report had the auditor then been aware of such facts. After determining that the information is reliable, the auditor should next:
(1) Notify the board of directors that the auditor's report must no longer be associated with the financial statements.
(2) Determine whether there are persons relying or likely to rely on the financial statements who would attach importance to the information.
(3) Request that management disclose the effects of the newly discovered information by adding a note to subsequently issued financial statements.
(4) Issue revised pro forma financial statements taking into consideration the newly discovered information.

f. Which of the following events occurring on January 5 of 19X2 is most likely to result in an adjusting entry to the 19X1 financial statements?
(1) A business combination.
(2) Early retirement of bonds payable.
(3) Settlement of litigation.
(4) Plant closure due to a strike.

Auditors Reports
Chapter Summary

This chapter explained the different types of reports that auditors issue to indicate the character of their audit and the degree of responsibility they are taking. To summarize:

1. The auditors' report should be viewed as a very carefully structured technical communication expressed in specialized terminology. The auditors' standard unqualified report includes an introductory paragraph, clarifying the responsibilities of management and the auditors; a scope paragraph, describing the nature of the audit; and an opinion paragraph, summarizing the auditors' opinion based on the audit. The report has a title that includes the word "independent," is addressed to the company whose financial statements are being audited or to its board of directors or stockholders, and is signed with the name of the CPA firm.

2. The auditors' alternatives when expressing an opinion are a standard unqualified opinion, an unqualified opinion with explanatory language, a qualified opinion, an adverse opinion, and a disclaimer of opinion. Figure 18–3 provides details on the appropriate modifications required for each of these types of reports.
3. When a client presents comparative financial statements for one or more prior periods with the current-period financial statements, the auditors should make certain that all periods are covered by an audit report. Audit reports on prior periods should be updated based on any new information that might affect the auditors' opinion. When predecessor auditors audited the prior-period financial statements, the successor auditors may summarize the predecessor auditors' opinion in the current-year audit report, or the client may arrange to have the predecessor auditors reissue their audit report.
4. Auditors of publicly held corporations must understand the various reporting requirements of the Securities and Exchange Commission (SEC). The reports filed with the SEC must be in accordance with Regulation S-X, which governs the form and content of the corporation's financial statements.

KEY TERMS

Accounting change A change in an accounting principle, in an accounting estimate, or in the reporting entity. Changes in accounting principles and reporting entities result in an explanatory paragraph being added to the auditors' report.

Adverse opinion An opinion that the financial statements *do not* fairly present financial position, results of operations, and cash flows, in conformity with generally accepted accounting principles.

Disclaimer of opinion A form of report in which the auditors state that they do not express an opinion on the financial statements.

Explanatory paragraph A paragraph inserted in an auditors' report to explain a matter or to describe the reasons for giving an opinion that is other than unqualified.

Introductory paragraph The paragraph of the auditors' report in which the auditors indicate that they have audited the financial statements and that the financial statements are the responsibility of management.

Last day of field work The day upon which the auditors conclude their investigative procedures on a particular audit.

Material Being of substantial importance. Significant enough to affect evaluations or decisions by users of financial statements. Information that should be disclosed in order for the financial statements to constitute a fair presentation. It involves both quantitative and qualitative criteria.

Opinion paragraph The paragraph of an auditors' report that communicates the degree of responsibility that the auditors are taking for the financial statements.

Principal auditors Auditors who use the work and reports of other independent CPAs who have audited the financial statements of one or more subsidiaries, branches, or other segments of the principal auditors' client.

Qualified opinion A modification of the auditors' standard report, employing an *except for* clause to limit the auditors' opinion on the financial statements. A qualified opinion indicates that except for some limitation on the scope of the audit or some departure from generally accepted accounting principles, the financial statements are fairly presented.

Select the best answer for each of the following and explain fully the reason for your selection:

a. A material departure from generally accepted accounting principles will result in auditor consideration of:

(1) Whether to issue an adverse opinion rather than a disclaimer if opinion.
(2) Whether to issue a disclaimer of opinion rather than an "except for" opinion.
(3) Whether to issue an adverse opinion rather than an "except for" opinion.
(4) Nothing, because none of these opinions is applicable to this type of exception.

b. The auditors' report should be dated as of the date the:

(1) Report is delivered to the client.
(2) Field work is completed.
(3) Fiscal period under audit ends.
(4) Review of the working papers is completed.

c. In the report of the principal auditor, reference to the fact that a portion of the audit was made by another auditor is:

(1) Not to be construed as a qualification, but rather as a division of responsibility between the two CPA firms.
(2) Not in accordance with generally accepted auditing standards.
(3) A qualification that lessens the collective responsibility of both CPA firms.
(4) An example of a dual opinion requiring the signatures of both auditors.

d. Assume that the opinion paragraph of an auditor's report begins as follows: "With the explanation given in note 6, the financial statements referred to above present fairly" This is:

(1) An unqualified opinion.
(2) A disclaimer of opinion.
(3) An "except for" opinion.
(4) An improper type of reporting.

e. The auditor who wishes to indicate that the entity has significant transactions with related parties should disclose this fact in:

(1) An explanatory paragraph to the auditors' report.
(2) An explanatory footnote to the financial statements.
(3) The body of the financial statements.
(4) The "summary of significant accounting policies" section of the financial statements.

Other Attestation and accounting services
Chapter Summary

This chapter described accounting and attestation services other than audits of financial statements in accordance with generally accepted accounting principles. To summarize:

1. The attestation standards provide for three distinct types of engagements—examinations, reviews, and agreed-upon procedures.
2. Special reports by auditors refer to those on: *(a)* financial statements prepared in accordance with some other comprehensive basis of accounting; *(b)* specified elements, accounts, or items of financial statements; *(c)* compliance with contractual

or regulatory requirements; *(d)* special-purpose financial presentations; and *(e)* financial information presented in prescribed forms or schedules.

3. There are several major differences between personal financial statements and those of other types of organizations. For example, assets and liabilities on personal financial statements are presented at their estimated current values and amounts. Accountants may audit, review, or compile personal financial statements.
4. Management of a public company may engage CPAs to review the company's interim financial statements. If they are also engaged to issue a report, it will provide limited assurance that the financial statements contain no material departures from GAAP. The procedures performed in a review engagement consist of performing analytical procedures, making inquiries of management, reviewing minutes, and obtaining written representations from management. The accountants will adjust the specific procedures based on their knowledge of the client's internal control structure and business.
5. Nonpublic companies may engage CPAs to review their annual or interim financial statements. The procedures involved are similar to those for the review of a public company, although the accountants are not required to obtain an understanding of the internal control structure of a nonpublic company.
6. Letters for underwriters (comfort letters) provide assurance about various information contained in registration statements used for the sale of securities. They are designed to help the underwriters establish their due diligence requirement in investigating the fairness of the registration statement.
7. Auditors may perform examinations, compilations, or agreed-upon procedures on prospective financial statements. The examination report includes an opinion that provides a conclusion on whether the underlying assumptions provide a reasonable basis for management's forecast or projection.
8. Auditors are being asked to provide assurance about management's representations about the effectiveness of internal control. Such reports are based on control criteria, such as those contained in *Internal Control—Integrated Framework* developed by the Committee of Sponsoring Organizations of the Treadway Commission.
9. When accountants perform compilations of financial statements or other information, the report provides no explicit assurance. Therefore, compilations may be performed by CPAs who are not independent.

KEY TERMS

Attestation To provide assurance as to whether information is presented in accordance with appropriate criteria. That is, to bear witness as to its reliability and fairness.

Comfort letter A letter issued by the independent auditors to the underwriters of securities registered with the SEC under the Securities Act of 1933. Comfort letters deal with such matters, as the auditors' independence and the compliance of unaudited data with requirements of the SEC.

Compilation An accounting service that involves the preparation of information from client records. No assurance is provided in a compilation.

Control criteria The reasonable criteria required to be followed by a company requesting a CPA's report on the effectiveness of its internal control structure.

Financial forecast Prospective financial statements that present an entity's expected financial position, results of operations, and cash flows for one or more future periods.

Financial projection Prospective financial statements that present expected results, given one or more hypothetical assumptions.

Limited assurance (negative assurance) Assurance provided by CPAs who have performed an attestation service of a lesser scope than an examination (e.g., a review). Provides substantially less assurance than is provided by an examination.

Management report on internal control A report by management that includes an assertion about the effectiveness of the company's internal control structure in meeting some established control criteria.

Negative assurance An assertion by CPAs that after applying limited investigative techniques to certain information, they are not aware of the need to modify the presentation of the information. Equivalent to limited or moderate assurance.

Nonpublic company A company other than one whose securities are traded on a public market or one that makes a filing with a regulatory agency in preparation for sale of securities on a public market.

Prospective financial statements Either financial forecasts or financial projections, including the summaries of significant assumptions and accounting policies.

Public company A company whose stock is traded on a public market or a company in the process of registering its stock for public sale.

Report on internal control This type of report may be either based on an examination of internal control or based on the performance of agreed-upon procedures.

Review A form of attestation based on limited procedures, such as inquiry and analytical procedures applied for the purpose of expressing limited assurance that information is presented in accordance with appropriate criteria.

Special report An auditors' report issued on any of the following: (1) financial statements prepared on a comprehensive basis of accounting other than GAAP, (2) elements of financial statements, (3) compliance with regulatory or contractual requirements, (4) financial presentations to comply with contractual agreements or regulatory provisions, or (5) audited information presented in prescribed forms.

Select the best answer for each of the following and explain fully the reason for your selection.

a. Which of the following is *not* typically performed when the auditors are performing a review of client financial statements?
   (1) Analytical procedures applied to financial data.
   (2) Inquiries about significant subsequent events.
   (3) Inquiries directed to the client's legal counsel.
   (4) Obtaining an understanding of accounting principles followed in the client's industry.

b. Which of the following forms of accountant association always leads to a limited distribution report?
   (1) Compilation.
   (2) Review.
   (3) Examination.
   (4) Agreed-upon procedures.

c. Which assertion is generally most difficult to attest to with respect to personal financial statements?
(1) Existence and occurrence.
(2) Rights and obligations.
(3) Completeness.
(4) Valuation.

d. Special reports are appropriate for:
(1) Reviews of interim statements.
(2) Compliance with regulatory requirements related to audited financial statements.
(3) Forecasts.
(4) Projections.

e. In which of the following reports should a CPA *not* express negative (limited) assurance?
(1) A standard compilation report on financial statements of a nonpublic entity.
(2) A standard review report on interim financial statements of a public entity.
(3) A standard review report on financial statements of a nonpublic entity.
(4) A comfort letter on financial information included in a registration statement filed with the Securities and Exchange Commission.

f. Comfort letters to underwriters are normally signed by the:
(1) Independent auditor.
(2) Underwriter.
(3) Client's lawyer.
(4) Chief executive officer.

Internal, Operational and Compliance Auditing

Summary

This chapter described internal, operational, and compliance auditing. To summarize:

1. Internal auditing is defined by the Institute of Internal Auditors (IIA) as an appraisal activity established within an organization as a service to the organization. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls. The IIA's professional standards encompass internal auditing independence, professional proficiency, appropriate scope of services, performance of audit work, and the management of the internal auditing department.
2. An operational audit is the examination of an operating unit or a complete organization to evaluate its performance, as measured by management's objectives. The stages of an operational audit might be summarized as definition of purpose, familiarization, preliminary survey, program development, field work, reporting the findings, and follow-up.
3. Compliance auditing involves testing and reporting on whether an organization has complied with the requirements of various laws, regulations and agreements.

4. The objective of a compliance audit engagement is the issuance of a report on an assertion by management regarding the organization's compliance with specified requirements, or regarding the organization's internal control structure over compliance with laws or regulations.
5. The objectives of compliance auditing of federal financial assistance programs are (a) to determine whether there have been violations of laws and regulations that may have a material effect on the organization's financial statements, and (b) to provide a basis for additional reports on compliance. Compliance auditing is involved in (a) audits of financial statements in accordance with generally accepted auditing standards, (b) audits conducted in accordance with *Government Auditing Standards,* and (c) audits conducted in accordance with the federal Single Audit Act of 1984 or *OMB Circular A-133.*
6. Audits of governmental organizations in accordance with generally accepted auditing standards must reflect the fact that such organizations are subject to a variety of laws and regulations that may have a direct and material effect on the amounts in the organization's financial statements.
7. In audits in accordance with *Government Auditing Standards,* the auditors issue a report on the financial statements, and report on compliance with laws and regulations, and on the internal control structure.
8. Audits in conformity with the Single Audit Act of 1984 or *OMB Circular A-133* are specifically designed to help ensure that the billions of dollars in federal financial assistance are appropriately spent. The focus of these audits is on organizations receiving $100,000 or more in federal assistance in a year. The auditors are required to report on general and specific requirements of programs for which federal assistance has been received.

KEY TERMS

Certified Internal Auditor An individual who has passed an examination administered by the Institute of Internal Auditors and has met the experience requirements necessary to become certified.

Compliance auditing Performing procedures to test compliance with laws and regulations.

Compliance Supplements Publications of the U.S. Office of Management and Budget that specify audit procedures for federal financial assistance programs. There is a compliance supplement for state and local governments and one for institutions of higher educations and other nonprofit institutions.

Compliance with specified requirements An entity's compliance with specified requirements of laws, regulations, rules, contracts, or grants.

General requirements Requirements involving significant national policy that apply to all or most federal financial programs.

Government Auditing Standards Standards issued by the U.S. General Accounting Office as the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions,* commonly referred to as the "Yellow Book."

Institute of Internal Auditors (IIA) The international professional organization of internal auditors.

Internal auditing An independent appraisal activity established within an organization as a service to the organization. It is a control that functions by examining and evaluating the adequacy and effectiveness of other controls.

Internal control structure over compliance The process by which management obtains reasonable assurance of compliance with specified laws and regulations.

Major federal financial assistance program (award) Any program or award with expenditures in excess of the amounts specified by the Single Audit Act for governmental organizations, or by *OMB Circular A-133* for colleges, universities, and other nonprofit institutions.

Management's Assertion Any declaration, or set of related declarations taken as a whole, made by management. In the context of compliance attestation, management's assertion deals with the entity's compliance with specified requirements, the effectiveness of the entity's internal control structure over compliance, or both.

Noncompliance The failure to act in accordance with laws, regulations, agreements, or grants.

Nonmajor federal financial assistance program (award) Any program or award that does not meet the criteria to be classified as a major program or award.

OMB Circular A-128 A publication of the U.S. Office of Management and Budget, titled "Audits of State and Local Governments," that provides guidance in implementing the Single Audit Act of 1984.

OMB Circular A-133 A publication of the U.S. Office of Management and Budget, titled "Audits of Institutions of Higher Education and Other Nonprofit Institutions," that establishes audit requirements for these organizations that are similar to those required for governmental organizations under the Single Audit Act of 1984.

Operational auditing The process of reviewing a department or other unit of a business, governmental, or nonprofit organization to measure the effectiveness, efficiency, and economy of operations.

Primary recipient An organization receiving federal financial assistance directly from the federal agency administering the program.

Select the best answer for each of the following questions. Explain the reasons for your selection.

a. Internal auditing can best be described as:
(1) An accounting function.
(2) A compliance function.
(3) An activity primarily to detect fraud.
(4) A control function.

(CIA, adapted)

b. The independence of the internal auditing department will most likely be assured if it reports to the:
(1) Audit committee of the board of directors.
(2) President.
(3) Controller.
(4) Treasurer.

(CIA, adapted)

c. When performing an operational audit, the purpose of a preliminary survey is to:
(1) Determine the objective of the activity to be audited.
(2) Determine the scope of the audit.
(3) Identify areas that should be included in the audit program.
(4) All of the above.

(CIA, adapted)

d. Operational auditing is primarily oriented toward:
(1) Future improvements to accomplish the goals of management.
(2) Ensuring the accuracy of the data in management's financial reports.
(3) Determination of the fairness of the entity's financial statements.
(4) Compliance with laws and regulations.

e. Which of the following bodies promulgates standards for audits of federal financial assistance programs?
(1) Governmental Accounting Standards Board.
(2) Financial Accounting Standards Board.
(3) General Accounting Office.
(4) Governmental Auditing Standards Board.

(AICPA, adapted)

f. As compared to an audit in accordance with GAAS, an audit in accordance with *Government Auditing Standards* requires the auditors to:
(1) Perform additional compliance auditing procedures.
(2) Perform additional tests of the internal control structure.
(3) Issue additional reports on compliance with laws and regulations and the internal control structure.
(4) Fulfill all of the above requirements.

Question:-

a) You are a manager in Farhan & Co, responsible for the audit of SAMSUNG Co, a company which produces circuit boards which are sold to manufacturers of electrical equipment such as computers and mobile phones. It is the first time that you have managed this audit client, taking over from the previous audit manager, Buland Iqbal, last month.

The audit planning for the year ended 30 November 2012 is about to commence, and you have just received an email from Munir, the audit engagement partner.

> **To: Audit manager**
> **From: Munir, Audit partner, Farhan & Co**
> **Subject: SAMSUNG Co – audit planning**
>
> ---
>
> **Hello**
>
> I am meeting with the other audit partners tomorrow to discuss forthcoming audits and related issues. I understand that you recently had a meeting with Waqar, the finance director of SAMSUNG Co. Using the information from your meeting, I would like you to prepare briefing notes for my use in which you:
>
> **i.** Evaluate the business risks faced by SAMSUNG Co;
>
> **ii.** Identify and explain FOUR risks of material misstatement to be considered in planning the audit; and
>
> **iii.** Discuss any ethical issues raised, and recommend the relevant actions to be taken by our firm.
>
> **Thank you.**

Comments made by Waqar in your meeting

Business overview

SAMSUNG Co's principal business activity remains the production of circuit boards. One of the key materials used in production is copper wiring, all of which is imported. As a cost cutting measure, in April 2012 a contract with a new overseas supplier was signed, and all of the company's copper wiring is now supplied under this contract. Purchases are denominated in a foreign currency, but the company does not use forward exchange contracts in relation to its imports of copper wiring.

SAMSUNG Co has two production facilities, one of which produces goods for the export market, and the other produces goods for the domestic market. About half of its goods are exported, but the export market is suffering due to competition from cheaper producers overseas. Most domestic sales are made under contract with approximately 20 customers.

Recent developments

In early November 2012, production was halted for a week at the production facility which supplies the domestic market. A number of customers had returned goods, claiming faults in the circuit boards supplied. On inspection, it was found that the copper used in the circuit boards was corroded and therefore unsuitable for use. The corrosion is difficult to spot as it cannot be identified by eye, and relies on electrical testing. All customers were contacted immediately and, where necessary, products recalled and replaced. The corroded copper remaining in inventory has been identified and separated from the rest of the copper.

Work has recently started on a new production line which will ensure that SAMSUNG Co meets new regulatory requirements prohibiting the use of certain chemicals, which come into force in March 2013. In July 2012, a loan of Rs.30 million with an interest rate of 4% was negotiated with SAMSUNG Co's bank, the main purpose of the loan being to fund the capital expenditure necessary for the new production line. Rs.2.5 million of the loan represents an overdraft which was converted into long-term finance.

Other matters

Several of SAMSUNG Co's executive directors and the financial controller left in October 2012, to set up a company specialising in the recycling of old electronic equipment. This new company is not considered to be in competition with SAMSUNG Co's operations. The directors left on good terms, and replacements for the directors have been recruited. One of Farhan & Co's audit managers, Buland Iqbal, is being interviewed for the role of financial controller at SAMSUNG Co. Bob is a good candidate for the position, as he developed good knowledge of SAMSUNG Co's business when he was managing the audit.

At SAMSUNG Co's most recent board meeting, the audit fee was discussed. The board members expressed concern over the size of the audit fee, given the

company's loss for the year. The board members would like to know whether the audit can be performed on a contingent fee basis.

Financial Information provided by Waqar

Extract from draft statement of comprehensive income for the year ended 30 November 2012

	2012 Draft Rs.' 000	**2011 Actual Rs.' 000**
Revenue	12,500	13,800
Operating costs	(12,000)	(12,800)
Operating profit	500	1,000
Finance costs	(800)	(800)
Profit/(loss) before tax	(300)	200

The draft statement of financial position has not yet been prepared, but Mo states that the total assets of SAMSUNG Co at 30 November 2012 are Rs.180 million, and cash at bank is Rs.130,000. Based on draft figures, the company's current ratio is 1.1, and the quick ratio is 0.8.

Required:

Respond to the email from the audit partner.

Note: The split of the mark allocation is shown within the partner's email.

Professional marks will be awarded for the presentation, structure, logical flow and clarity of your answer.

b) You have just received a phone call from Waqar, SAMSUNG Co's finance director, in which he made the following comments:

'There is something I forgot to mention in our meeting. Our business insurance covers us for specific occasions when business is interrupted. I put in a claim on 28 November 2012 for Rs.5 million which I have estimated to cover the period when our production was halted due to the problem with the corroded copper. This is not yet recognised in the financial statements, but I want to make an adjustment to recognise the Rs.5 million as a receivable as at 30 November.'

Required:

Comment on the matters that should be considered, and recommend the audit procedures to be performed, in respect of the insurance claim.

Answer:-

a) **Briefing notes**
To: Audit Partner
From: Audit Manager
Regarding: Audit planning and ethical issues in respect of SAMSUNG Co

Introduction

These briefing notes evaluate the business risks facing SAMSUNG Co, and identify and explain four risks of material misstatement to be considered in planning the audit of the financial statements for the year ended 30 November 2012. In addition, two ethical issues are discussed and relevant actions recommended.

i. **Business risks**

Imported goods – exchange rate fluctuations

SAMSUNG Co relies on a key component of its production process being imported from overseas. This exposes the company to exchange rate volatility and consequentially cash flow fluctuations. The company chooses not to mitigate this risk by using forward exchange contracts, which may not be a wise strategy for a business so reliant on imports. Exchange gains and losses can also cause volatility in profits, and as the company already has a loss for the year, any adverse movements in exchange rates may quickly increase this loss.

Imported goods – transportation issues

Heavy reliance on imports means that transportation costs will be high, and with fuel costs continuing to increase this will put pressure on SAMSUNG Co's margins. It is not just the cost that is an issue – reliance on imports is risky as supply could be disrupted due to aviation problems, such as the grounding of aircraft after volcanic eruptions or terrorist activities.

Reliance on imported goods increases the likelihood of a stock out. Unless SAMSUNG Co keeps a reasonable level of copper wiring as inventory, production would have to be halted if supply were interrupted, creating idle time and inefficiencies, and causing loss of customer goodwill.

Reliance on single supplier

All of SAMSUNG Co's copper wiring is supplied by one overseas supplier. This level of reliance is extremely risky, as any disruption to the supplier's operations, for example, due to financial difficulties or political interference, could result in the curtailment of supply, leading to similar problems of stock outs and halted production as discussed above.

Quality control issues

Since appointing the new supplier of copper wiring, SAMSUNG Co has subsequently experienced quality control issues with circuit boards, which could result in losing customers (discussed further below). This may have been due to changing supplier as part of a cost-cutting exercise. Given that the new supplier is overseas, it may make resolving the quality control issues more difficult. Additional costs may have to be incurred to ensure the quality of goods received, for example, extra costs in relation to electrical testing of the copper wiring. The company's operating margins for 2012 are already low at only 4% (2011 – 7.2%), and additional costs will put further pressure on margins.

High-technology and competitive industry

SAMSUNG Co sells into a high-technology industry, with computers and mobile phones being subject to rapid product development. It is likely that SAMSUNG Co will need to adapt quickly to changing demands in the marketplace, but it may not have the resources to do this.

SAMSUNG Cooperates in a very competitive market. With many suppliers chasing the same customer base, there will be extreme pressure to cut prices in order to remain competitive. As discussed above, the company's operating margins are already low, so competition based on price would not seem to be an option.

Reliance on key customers

SAMSUNG Co relies on only 20 key customers to generate its domestic revenue, which accounts for approximately half of its total revenue. In a competitive market, it may be difficult to retain customers without cutting prices, which will place further pressure on profit margins. In addition, the product quality issue in November could mean that some contracts are cancelled, despite SAMSUNG Co's swift action to recall defective items, meaning a potentially significant loss of revenue.

Furthermore, SAMSUNG Co will have to refund dissatisfied customers or supply alternative products to them, putting strain on cash flows and operating margins.

Regulatory issues

New regulations come into force within a few months of the year end. It would appear that the existing production facilities do not comply with these regulations, and work has only recently begun on the new and regulation-compliant production line, so it is very unlikely that the new regulations can be complied with in time. This creates a significant compliance risk for SAMSUNG Co, which could lead to investigation by the regulatory authority, and non-compliance may result in forced cessation of production, fines, penalties and bad publicity. There may also be additional on-going costs involved in complying with the new regulations, for example, monitoring costs, as well as the costs of the necessary capital expenditure.

Additional finance taken out – liquidity/solvency issues

A loan representing 16.7% of total assets was taken out during the year. This is a significant amount, increasing the company's gearing, and creating an obligation to fund interest payments of Rs.1.2 million per annum, as well as repayments of capital in the future. SAMSUNG Co does not appear to be cash-rich, with only Rs.130,000 cash available at the year end, and having built up an overdraft of Rs.2.5 million in July, working capital management may be a long-term problem for the company. The current and quick ratios also indicate that SAMSUNG Co would struggle to pay debts as they fall due.

Profitability

The draft statement of comprehensive income indicates that revenue has fallen by 9.4%, and operating profit fallen by 50%. Overall, the company has made a loss for the year. In 2012 finance charges are not covered by operating profit, and it would seem that finance charges may not yet include the additional interest on the new loan, which would amount to Rs.500,000 (Rs.30m x 4% x 5/12). The inclusion of this additional cost would increase the loss for the year to Rs.800,000. This may indicate going concern problems for the company.

Change in key management

The loss of several directors during the year is a business risk as it means that the company may lose important experience and skills. It will take time for the new directors to build up business knowledge and to develop and begin to implement successful business strategies.

ii. Risks of material misstatement

Foreign currency transactions – initial recognition

The majority of SAMSUNG Co's copper wiring is imported, leading to risk in the accounting treatment of foreign currency transactions. According to IAS 21 The Effects of Changes in Foreign Exchange Rates, foreign currency transactions should be initially recognised having been translated using the spot rate, or an average rate may be used if exchange rates do not fluctuate significantly. The risk on initial recognition is that an inappropriate exchange rate has been used in the translation of the amount, causing an inaccurate expense, current liability and inventory valuation to be recorded, which may be over or understated in value.

Foreign currency transactions – exchange gains and losses

Further risk arises in the accounting treatment of balances relating to foreign currency at the year end. Payables denominated in a foreign currency must be retranslated using the closing rate, with exchange gains or losses recognized in profit or loss for the year. The risk is that the yearend retranslation does not take place, or that an inappropriate exchange rate is used for the retranslation, leading to over or understated current liabilities and operating expenses. Risk also exists relating to transactions that are settled within the year, if the correct exchange gain or

loss has not been included in profit. Inventory should not be retranslated at the yearend as it is a non-monetary item, so any retranslation of inventory would result in over or undervaluation of inventory and profit.

Product recall – obsolete inventory

There is a quantity of copper wiring which appears to have no realisable value as it has been corroded and cannot be used in the production of circuit boards. This inventory should be written off, as according to IAS 2 Inventories, measurement should be at the lower of cost and net realisable value. The risk is that inventory has not been reduced in value, leading to overstated current assets and overstated operating profit. The risk is heightened if SAMSUNG Co has not adequately identified and separated the corroded copper wiring from the rest of its inventory. This is quite likely, given that the corrosion cannot be spotted visually and relies on the copper being tested.

Product recall – refunds to customers

Due to the faulty items being recalled, some customers may have demanded a refund instead of a replacement circuit board. If the customer had already paid for the goods, a provision should be recognised for the refund, as the original sale and subsequent product recall would create an obligation. If the customer had not already paid for the goods and did not want a replacement, then the balance on the customer's receivables account should be written off. Depending on whether the customer had paid before the year end, there is a risk of overstated profits and either understated provisions or overstated current assets if the necessary adjustment for any refunds is not made.

Additional finance – capitalisation of new production line

The new production process would appear to be a significant piece of capital expenditure, and it is crucial that directly attributable costs are appropriately capitalised according to IAS 16 Property, Plant and Equipment and IAS 23 Borrowing Costs. Directly attributable finance costs must be capitalised during the period of construction of the processing line, and if they have not been capitalised, non-current assets will be understated and profit understated. There is also a risk that due to the company's low level of profit, there is pressure on management to

understate expenses. This could be achieved by treating items of revenue expenditure as capital expenditure, which would overstate non-current assets and overstate profit.

New regulations – valuation of existing production facilities
There is a risk that the existing production facilities are impaired. This is due to the new regulations which come into force next year, and may make at least part of the existing facilities redundant when the new production line is ready for use. IAS 36 Impairment of Assets identifies adverse changes in the legal environment as an external indicator of potential impairment. If management does not perform an impairment review to identify the recoverable amount of the production facilities, then the carrying value may be overstated. Profit would also be overstated if the necessary impairment loss were not recognised.

Additional finance – measurement and disclosure of loan
The loan taken out is a financial liability and must be accounted for in accordance with IFRS 9 Financial Instruments, which states that financial liabilities must be classified and measured at amortised cost using the effective interest method (unless an option is taken to measure at fair value). The risk is that amortised cost has not been applied, meaning that finance costs have not accrued on the loan. The fact that the finance cost in the draft statement of comprehensive income has remained static indicates that this may have happened, resulting in understated finance costs and understated liabilities.

There is also a risk that necessary disclosures under IFRS 7 Financial Instruments: Disclosures have not been made. The notes to the financial statements should contain narrative and numerical disclosures regarding risk exposures, and given the materiality of the loan, it is likely that disclosure would be necessary.
Note: More than the required number of four risks of material misstatement have been identified and explained in the answer above. Credit will be awarded for any four relevant risks, such as cut-off problems in relation to overseas transactions.

iii. Ethical issues

An audit manager of Farhan & Co is being interviewed for the position of financial controller at SAMSUNG Co. This creates a potential ethical threat. According to IFAC's Code of Ethics for Professional Accountants, familiarity or intimidation threats may be created by employment with an audit client.

The familiarity threat is caused by the relationship that Buland Iqbal will have with the audit team, having worked at the firm. This may cause the audit team to lose objectivity, fail to challenge him sufficiently and lose professional skepticism. The more junior members of the audit team may also feel intimidated by him as his previous position was as audit manager. He will also be aware of the firm's audit methodology and procedures, making it easier for him to circumvent procedures.

IFAC's Code states that if a former member of the audit team or partner of the firm has joined the audit client in a position that can influence the preparation of the financial statements, and a significant connection remains between the firm and the individual, the threat would be so significant that no safeguards could reduce the threat to an acceptable level. Therefore it is crucial that Farhan & Co ensures that no significant connection between the audit firm and Buland Iqbal remains, for example, by ensuring that he does not continue to participate or appear to participate in the firm's business or professional activities, and by making sure that he is not owed any material sum of money from the audit firm. If a significant connection were to remain, then the threat to objectivity would be unacceptably high, and Farhan & Co would have to consider resigning as auditors of SAMSUNG Co.

In the event of Buland Iqbal accepting the position and no significant connection between him and the firm remaining, the existence and significance of familiarity and intimidation threats would need to be considered and appropriate safeguards, such as modifying the audit plan and changing the composition of the audit team, put in place.

Any work that Buland Iqbal may have recently performed on SAMSUNG Co should be subject to review, as there may have been a self-interest threat if Bob knew he was going to apply for the role at the same time as performing work for the client. However, as audit planning has yet to commence, this may not be an important issue.

Farhan & Co should have in place policies and procedures which require members of an audit team to notify the audit firm when entering employment negotiations with the client, as required by IFAC's Code. The firm's policies and procedures should be reviewed to ensure they are adequate and they may need to be communicated again to members of staff.

Note: It is not certain or even implied that Bob has deliberately tried to hide his intention to join SAMSUNG Co – but credit will be awarded where candidates assume this to be the case. Equally, credit will be awarded for comments recognising that it is appropriate that Bob has been removed from the audit team.

As to the comment regarding whether the audit can be conducted on a contingent fee basis, this is not allowed according to IFAC's Code. Contingent fee arrangements in respect of audit engagements create self-interest threats to the auditor's objectivity and independence that are so significant that they cannot be eliminated or reduced to an acceptable level by the application of any safeguards.

The audit fee must not depend on contingencies such as whether the auditor's report on the financial statements is qualified or unqualified. The basis for the calculation of the audit fee is agreed with the audited entity each year before significant audit work is undertaken.

Conclusion

The audit of SAMSUNG Co should be approached as high risk, due to the number of business risks and risks of material misstatement explained in these briefing notes. An audit strategy must be developed to minimise the overall level of audit risk, and strong quality control procedures must be adhered to throughout the audit. In addition, the ethical issue relating to Buland Iqbal must be brought to the attention of our firm's Ethics Partner as soon as possible.

b) Matters to consider

The amount of Rs.5 million that has been claimed is material to the draft financial statements, representing 2.7% of total assets. It represents 40% of revenue for the

year, and if adjusted would turn the loss currently recognised of Rs.300,000 to a profit of Rs.4.7 million.

The claim represents a contingent asset, which, according to IAS 37 Provisions, Contingent Liabilities and Contingent Assets should not be recognised until such time as the inflow of economic benefits is virtually certain. If the inflow of benefits is probable rather than virtually certain, then the matter should only be disclosed in a note to the financial statements.

The issue here is whether the amount claimed can be considered as virtually certain or even probable to be received. The business insurance taken out by SAMSUNG Co might only cover business interruption caused by certain circumstances or events, such as terrorist acts or natural disasters. And it may only apply if the whole business operation is curtailed, rather than just activities in one location.

The amount claimed appears unrealistic. Production was halted for one week at one location only, so to claim an amount equivalent to 40% of the company's total annual revenue seems extreme, making it very unlikely that the claim would be approved by the insurance provider.
For these reasons, an adjustment to the financial statements would seem inappropriate, certainly until confirmation has been received from the insurance provider. If the financial statements are adjusted to include a receivable of Rs.5 million, the audit firm should consider this as a very high risk issue, because of the potential impact on the auditor's report of the potentially material and possibly pervasive misstatement.

Recommended procedures

- Obtain a copy of the insurance claim made and confirm that Rs.5 million is the amount claimed.
- Enquire as to the basis of the Rs.5 million claimed, and review any supporting documentation such as extracts of management accounts showing lost income for the period of halted production.
- Scrutinise the terms of SAMSUNG Co's insurance policy, to determine whether production halted in SAMSUNG Co's circumstances would be covered.

- Seek permission to contact the insurance provider to enquire as to the status of the claim, and attempt to receive written confirmation of the likelihood of any payment being made.
- Review correspondence between SAMSUNG Co and the insurance provider, looking for confirmation of any amounts to be paid.
- Contact SAMSUNG Co's lawyers to enquire if there have been any legal repercussions arising from the insurance claim, for example, the insurance company may have disputed the claim and the matter may now be in the hands of legal experts.

Question:-

a) You are a manager in KPMG, responsible for the audit of the Imran Group (the Group), which is listed. The Group's main activity is steel manufacturing and it comprises a parent company and five subsidiaries. KPMG currently audits all components of the Group.

   You are working on the audit of the Group's financial statements for the year ended 30 June 2012. This morning the audit engagement partner left a note for you:

   'Hello

   The audit senior has provided you with the draft consolidated financial statements and accompanying notes which summarise the key audit findings and some background information.

   At the planning stage, materiality was initially determined to be Rs.900,000, and was calculated based on the assumption that the Imran Group is a high risk client due to its listed status. During the audit, a number of issues arose which meant that we needed to revise the materiality level for the financial statements as a whole. The revised level of materiality is now determined to be Rs.700,000. One of the audit juniors was unsure as to why the materiality level had been revised. There are two matters you need to deal with:

   i. Explain why auditors may need to reassess materiality as the audit progresses.
   ii. Assess the implications of the key audit findings for the completion of the audit. Your assessment must consider whether the key audit findings indicate a risk of material misstatement. Where the key audit findings refer to audit evidence, you must also consider the adequacy of the audit

evidence obtained, but you do not need to recommend further specific procedures.

Thank you'

The Group's draft consolidated financial statements, with notes referenced to key audit findings, are shown below:

Draft consolidated statement of comprehensive income

	Note	30 June 2012 Draft Rs.'000	30 June 2011 Actual Rs.'000
Revenue	1	98,795	103,100
Cost of sales		(75,250)	(74,560)
Gross profit		23,545	28,540
Operating expenses	2	(14,900)	(17,500)
Operating profit		8,645	11,040
Share of profit of associate		1,010	900
Finance costs		(380)	(340)
Profit before tax		9,275	11,600
Taxation		(3,200)	(3,500)
Profit for the year		6,075	8,100
Other comprehensive income/expense for the year, net of tax			
Gains on property revaluation	3	800	------
Actuarial losses on defined benefit plan	4	(1,100)	(200)
Other comprehensive income/expense		(300)	(200)
Total comprehensive income for the year		5,775	7,900

Notes: Key audit findings – statement of comprehensive income

1. Revenue has been stable for all components of the Group with the exception of one subsidiary, Copeland Co, which has recognised a 25% decrease in revenue.
2. Operating expenses for the year to June 2012 is shown net of a profit on a property disposal of Rs2 million. Our evidence includes agreeing the cash receipts to bank statement and sale documentation, and we have confirmed that the property has been removed from the non-current asset register. The audit junior noted when reviewing the sale document, that there is an option

to repurchase the property in five years time, but did not discuss the matter with management.

3. The property revaluation relates to the Group's head office. The audit team have not obtained evidence on the revaluation, as the gain was immaterial based on the initial calculation of materiality.
4. The actuarial loss is attributed to an unexpected stock market crash. The Group's pension plan is managed by Alico Co – a firm of independent fund managers who maintain the necessary accounting records relating to the plan. Alico Co has supplied written representation as to the value of the defined benefit plan's assets and liabilities at 30 June 2012. No other audit work has been performed other than to agree the figure from the financial statements to supporting documentation supplied by Alico Co.

Draft consolidated statement of financial position

	Note	30 June 2012 Draft Rs'000	30 June 2011 Actual Rs'000
ASSETS			
Non-current assets			
Property, plant and equipment		81,800	76,300
Goodwill	5	5,350	5,350
Investment in associate	6	4,230	4,230
Assets classified as held for sale	7	7,800	-----
		99,180	85,880
Current assets			
Inventory		8,600	8,000
Receivables		8,540	7,800
Cash and cash equivalents		2,100	2,420
		19,240	18,220
Total assets		118,420	104,100
EQUITY AND LIABILITIES			
Equity			
Share capital		12,500	12,500
Revaluation reserve		3,300	2,500
Retained earnings		33,600	29,400
Non-controlling interest	8	4,350	4,000
Total equity		53,750	48,400
Non-current liabilities			
Defined benefit pension plan		10,820	9,250
Long-term borrowings	9	43,000	35,000

Deferred tax	1,950	1,350
Total non-current liabilities	55,770	45,600
Current liabilities		
Trade and other payables	6,200	7,300
Provisions	2,700	2,800
Total current liabilities	8,900	10,100
Total liabilities	64,670	55,700
Total equity and liabilities	118,420	104,100

Notes: Key audit findings – statement of financial position

5. The goodwill relates to each of the subsidiaries in the Group. Management has confirmed in writing that goodwill is stated correctly, and our other audit procedure was to arithmetically check the impairment review conducted by management.
6. The associate is a 30% holding in James Co, purchased to provide investment income. The audit team have not obtained evidence regarding the associate as there is no movement in the amount recognised in the statement of financial position.
7. The assets held for sale relate to a trading division of one of the subsidiaries, which represents one third of that subsidiary's net assets. The sale of the division was announced in May 2012, and is expected to be complete by 31 December 2012. Audit evidence obtained includes a review of the sales agreement and confirmation from the buyer, obtained in July 2012, that the sale will take place.
8. Two of the Group's subsidiaries are partly owned by shareholders external to the Group.
9. A loan of Rs8 million was taken out in October 2011, carrying an interest rate of 2%, payable annually in arrears. The terms of the loan have been confirmed to documentation provided by the bank.

Required:

Respond to the note from the audit engagement partner.

Note: The split of the mark allocation is shown within the partner's note.

b) The audit engagement partner now sends a further note regarding the Imran Group:

'The Group finance director has just informed me that last week the Group purchased 100% of the share capital of May Co, a company located overseas in Farland. The Group audit committee has suggested that due to the distant location of May Co, a joint audit could be performed, starting with the next financial statements for the year ending 30 June 2013. May Co's current auditors are a small local firm called Moore & Co who operate only in Farland.'

Required:

Discuss the advantages and disadvantages of a joint audit being performed on the financial statements of May Co.

Answer:-

a) .

i. **Materiality**

Materiality is a matter of judgement, and is commonly determined using a numerical approach based on percentages calculated on revenue, profit before tax and total assets. ISA 320 Materiality in Planning and Performing an Audit requires that the auditor shall revise materiality for the financial statements as a whole in the event of becoming aware of information during the audit that would have caused the auditor to determine a different level of materiality initially.

It may be that during the audit, the auditor becomes aware of a matter which impacts on the auditor's understanding of the client's business and which leads the auditor to believe that the initial assessment of materiality was inappropriate and must be revised. For example, the actual results of the audit client may turn out to be quite different to the forecast results on which the initial level of materiality was based.

Or, a change in the client's circumstances may occur during the audit, for example, a decision to dispose of a major part of the business. This again would cause the auditor to consider if the previously determined level of materiality were still appropriate.

If adjustments are made to the financial statements subsequent to the initial assessment of materiality, then the materiality level would need to be adjusted accordingly.

The initial calculation of materiality for the Imran Group was based on the client's listed status, and therefore on an assumption of it being high risk. It is therefore important that any events, such as those explained above, are taken into account in assessing a new level of materiality for this client to ensure that sufficient appropriate evidence is obtained to support the audit opinion.

ii. **Audit implications**

Property disposal

A material profit has been recognised on the disposal of a property, and the asset derecognised. This may not be the correct accounting treatment, as the sales agreement contains an option to repurchase, and the transaction may be a financing arrangement rather than a genuine sale. Further work needs to be carried out to determine the substance of the transaction. If it is in substance a loan secured on the value of the property, then the asset should be reinstated and a loan payable recognised on the statement of financial position, with finance charges accruing according to IFRS 9 Financial Instruments. Profit is overstated by a material amount if the disposal has been incorrectly accounted for.

Revaluation

The revaluation gain recognised of Rs800,000 is below the level of materiality set initially which was Rs900,000. However, the level of materiality has now been revised to Rs700,000, meaning that the gain now needs to be subject to audit procedures to ensure there is no material misstatement. Further audit work may be needed to ensure that this is the only property that should be revalued, given that all assets in the same class should be subject to revaluation.

Actuarial loss

The loss recognised is material to the financial statements, but only limited procedures have been conducted. Alico Co is a service organisation, and audit procedures should be carried out according to ISA 402 Audit Considerations Relating to an Entity Using a Service Organisation. Auditors are required to gain an understanding of the service

organization either from the user entity, which in this case is the Imran Group (the Group), or by obtaining a report on the service organisation.

The procedures that have been conducted so far are not sufficient, as written confirmation and agreement to Alico Co's records do not provide evidence as to the basis of the valuation of the pension plan, which has a material impact on the Group financial statements. The audit team themselves should perform procedures to provide evidence as to the measurement of the plan and the actuarial loss, and not simply rely on the accounting records of the service organisation.

Goodwill impairment

Goodwill has remained at the same amount in the financial statements, but the goodwill may be overstated in value. One of the subsidiaries, Copeland Co, has suffered a 25% reduction in revenue. This is an indicator of impairment of goodwill, and a written representation and arithmetical check is not sufficient appropriate evidence for such a material and subjective matter. Further audit work should be conducted on management's assumptions used in the impairment review of goodwill relating to Copeland Co. As KPMG performs the audit of Copeland Co, the firm should have sufficient business understanding to challenge management's assumptions on the impairment review of goodwill.

Goodwill classification

A trading division relating to one-third of a subsidiary's net assets is held for sale at the year end. Any goodwill relating to this trading division should be reclassified out of goodwill and into the disposal group of assets held for sale. It may be a subjective and complex process to determine how much of the subsidiary's goodwill should be allocated to the trading division which is held for sale. It may be that no goodwill is attached to this trading division, but this should be confirmed through further audit procedures.

The two matters explained above both indicate that the Group's goodwill figure could be materially overstated and that further audit procedures should be performed.

Associate

The statement of financial position recognises an associate at Rs4.23 million in both the current and prior periods. It is unusual to see no movement in this figure, especially given that the statement of comprehensive income recognises a share of profit generated from the associate, which should normally result in an increase in the value of the associate recognised as an investment of the Group.

It is unacceptable not to obtain evidence in respect of the associate. The audit team should enquire as to the accounting entries that have been made in relation to the associate and confirm whether no movement in the investment is reasonable.

Assets held for sale

There seems to be incorrect and incomplete disclosure in relation to the disposal group of assets held for sale. As discussed above, it seems that no goodwill has been allocated to the disposal group, which needs further investigation. In addition, the disposal group of assets should not be disclosed under the non-current assets heading but should be disclosed in a separate category on the statement of financial position.

Also, any liabilities associated with the disposal group should be presented separately from other liabilities. It is not clear from the draft accounts whether the Rs7.8 million disclosed as assets held for sale is just non-current assets, or whether it is a net figure including both assets and liabilities. It is required by IFRS 5 Non-Current Assets Held for Sale and Discontinued Operations that the assets and liabilities of disposal groups should not be offset and must be presented separately within total assets and total liabilities. Therefore, procedures should be performed to determine how the Rs7.8 million has been calculated, and to ensure appropriate disclosure of any liabilities of the disposal group.

The assets of a disposal group should also be remeasured if necessary to fair value less cost to sell, if this is lower than carrying value. The audit team need to determine whether management has conducted a review of the value of assets held in the disposal group. The amounts recognised may be overstated.

Finally, the sale of the trading division would seem to meet the definition of a discontinued operation according to IFRS 5, as its assets were held for sale at the year end, and it is likely to constitute a separate major line of business. IFRS 5 requires that the face of the income statement discloses a single figure in respect of discontinued operations, comprising the post-tax profit or loss of the discontinued operation and the post-tax gain or loss recognised on any measurement of its assets to fair value, less cost to sell. The Group's income statement does not include any figure in relation to the trading division which is being sold. Audit procedures should be performed to determine whether this is necessary.

Regarding evidence obtained, the external confirmation from the buyer is a reliable source of evidence. However, it was obtained a number of months ago, since when circumstances may have changed. The buyer should be contacted again to reconfirm at a date closer to the signing of the audit report their intention to purchase the trading division.

Non-controlling interest

The statement of financial position correctly discloses the non-controlling interest as a component of equity, as required by IAS 1 Presentation of Financial Statements. However, the statement of comprehensive income does not disclose the profit for the year or total comprehensive income for the year attributable to the non-controlling interest. Therefore the audit team must enquire as to whether this disclosure will be made by management.

Finance cost

A loan of Rs8 million was taken out in October 2011, carrying a 2% interest charge. This would mean finance costs of Rs120,000 (Rs8 million x 2% x 9/12) should be accrued for. However, the Group's finance cost has increased by Rs40,000 only. Therefore the finance cost may not have been recognised in full, overstating profit and understating liabilities. Work should be performed to understand the components of the finance charge recognised, as other finance costs may have ceased during the year. The notes to the financial statements should also be reviewed to ensure there is adequate disclosure of the loan taken out.

b) In a joint audit, two or more audit firms are responsible for conducting the audit and for issuing the audit opinion. The main advantage of a joint audit of May Co is that the local audit firm's understanding and experience of May Co will be retained, and that will be a valuable input to the audit. At the same time, KPMG can provide additional skills and resources where necessary.

The country in which May Co is located may have different regulations to the rest of the Group, for example, there may be a different financial reporting framework. It makes sense for the local auditors, therefore, to retain some input to the audit as they will have detailed knowledge of such regulations.

The fact that May Co is located in a distant location means that from a practical point of view it may be difficult for KPMG to provide staff for performing the bulk of the audit work. It will be more cost effective for this to be carried out by local auditors.

Two audit firms can also stand together against aggressive accounting treatments. In this way, a joint audit works to enhance the quality of the audit. The benchmarking that takes place between the two firms raises the level of service quality.

The main disadvantage is that for the Group, having a joint audit is likely to be more expensive than appointing just one audit firm. However, the costs are likely to be less than if KPMG took sole responsibility, as having the current auditors retain an involvement will at least cut down on travel expenses. And the small local firm will probably offer a cheaper audit service than KPMG.

For the audit firms, there may be problems in deciding on responsibilities, allocating work, and they will need to work very closely together to ensure that no duties go underperformed, and that the quality of the audit is maintained.

Question:-

a) You are an audit manager in Kamran & Co, an audit firm which operates as part of an international network of firms. This morning you received a note from a partner regarding a potential new audit client:

'I have been approached by the audit committee of the Plant Group, which operates in the mobile telecommunications sector. Our firm has been invited to tender for the audit of the individual and group financial statements for the year ending 31 March 2013, and I would like your help in preparing the tender document. This would be a major new client for our firm's telecoms audit department.

The Plant Group comprises a parent company and six subsidiaries, one of which is located overseas. The audit committee is looking for a cost effective audit, and hopes that the strength of the Plant Group's governance and internal control mean that the audit can be conducted quickly, with a proposed deadline of 31 May 2013. The Plant Group has expanded rapidly in the last few years and significant finance was raised in July 2012 through a stock exchange listing.'

Required:
Identify and explain the specific matters to be included in the tender document for the audit of the Plant Group.

b) Kamran & Co is facing competition from other audit firms, and the partners have been considering how the firm's revenue could be increased. Two suggestions have been made:
   1. Audit partners and managers can be encouraged to sell non-audit services to audit clients by including in their remuneration package a bonus for successful sales.
   2. All audit managers should suggest to their audit clients that as well as providing the external audit service, Kamran & Co can provide the internal audit service as part of an 'extended audit' service.

Required:

Comment on the ethical and professional issues raised by the suggestions to increase the firm's revenue.

Answer:-

a) **Matters to be included in tender document**
Outline of Kamran & Co
A brief outline of the audit firm, including a description of different services offered, and the firm's membership of an international network of audit firms.

This should provide comfort to the Plant Group's audit committee that Kamran & Co has the capability to audit its overseas subsidiary, and that the audit firm has sufficient resources to conduct the Plant Group audit now and in the future, given the Plant Group's rapid expansion.

Specialisms of Kamran & Co

A description of areas of particular audit expertise, focusing on those areas of relevance to the Plant Group, namely the audit firm's telecoms audit department. The tender document should emphasise the audit firm's specialism in auditing this industry sector, which highlights that an experienced audit team can be assembled to provide a high quality audit.

Identify the audit requirements of the Plant Group

An outline of the requirements of the client, including confirmation that Kamran & Co would be providing the audit service to each subsidiary, as well as to the parent company, and to the Plant Group. Kamran & Co may also wish to include a clarification of the purpose and legal requirements of an audit in the jurisdictions of the components of the Plant Group, as requirements may differ according to geographical location.

Identify any audit-related services that may be required

Due to the Plant Group's listed status, there may be additional work to be performed. For example, depending on the regulatory requirements of the stock exchange on which the Plant Group is listed, there may be additional reporting requirements relevant to corporate governance and internal controls. This should be clarified and included in the tender document to ensure that the audit committee understands any such requirements, and that Kamran & Co can provide an all-encompassing service.

Audit approach

A description of the proposed audit approach, outlining the stages of the audit process and the audit methodology used by the firm. Kamran & Co may wish to emphasise any aspects of the proposed audit methodology which would be likely to meet the audit committee's requirement of a cost effective audit. The proposed audit approach could involve reliance to some extent on the Plant Group's controls, which are suggested to be good, and the tender document

should explain that the audit firm will have to gauge the strength of controls before deciding whether to place any reliance on them.

Deadlines

The audit firm should clarify the timescale to be used for the audit. This is very important, given the audit committee's hope for a quick audit. It would be time pressured for the audit of all components of the Plant Group and of the consolidated financial statements to be completed in two months, especially given the geographical spread of the Plant Group. The audit firm may wish to propose a later deadline, emphasising that it may be impossible to conduct a quality audit in such a short timeframe.

Quality control and ethics

Kamran & Co should clarify its adherence to IFAC's Code of Ethics for Professional Accountants, and to International Standards on Quality Control. This should provide assurance that the audit firm will provide an unbiased and credible audit report. This may be particularly important, given the recent listing obtained by the Plant Group, and consequential scrutiny of the financial statements and audit report by investors and potential investors.

Fees

The proposed audit fee should be stated, with a breakdown of the main components of the fee. The audit firm may wish to explain that the audit fee is likely to be higher in the first year of auditing the Plant Group, as the firm will need to spend time obtaining business understanding and ensuring there is appropriate documentation of systems and controls. The tender document could explain that the audit is likely to become more cost effective in subsequent years, when the audit firm has gone through a learning curve.

Note: Credit will also be awarded for alternative comments regarding fees, for example, candidates may suggest that the audit fee will be relatively constant year on year (the reason being that initial costs are not passed on to the client in the first year of providing the audit service).

Additional non-audit services

The audit firm should describe any non-audit services that it may be able to provide, such as tax services or restructuring services, which may be relevant

given the rapid expansion of the Plant Group. The provision of such services would have to be considered carefully by the audit firm due to the threat to objectivity that may be created, so the tender document should outline any safeguards that may be used to reduce risks to an acceptable level. This is particularly important, given the listed status of the Plant Group. This part of the tender document may remind the audit committee members that corporate governance requirements may prohibit the audit firm from offering certain non-audit services.

Note: Credit will be awarded for discussion of other matters that may be included in the tender document, if made relevant to the Plant Group.

b) Ethical issues

Kamran & Co must ensure that any efforts to increase the firm's revenue do not create any threats to objectivity and independence.

The suggestion to remunerate partners with a bonus on successful sale of a non-audit service to an audit client creates a potential self-interest threat to objectivity. IFAC's Code of Ethics for Professional Accountants states that a self-interest threat is created when a member of the audit team is evaluated on or compensated (remunerated) for selling non-assurance services to that audit client.

The significance of the threat depends on factors such as:

- The proportion of the individual's compensation or performance evaluation that is based on the sale of such services;
- The role of the individual on the audit team; and
- Whether promotion decisions are influenced by the sale of such services.

In this case, the fact that the remuneration will be paid to the partner creates a significant threat to objectivity due to their influential position in the audit team. IFAC's Code states that a key audit partner shall not be evaluated on or compensated (remunerated) based on that partner's success in selling non-assurance services to the partner's audit client. Therefore the bonus scheme should not be offered to partners as it creates an unacceptable threat to objectivity.

IFAC's Code does not specifically state that managers should not be evaluated or remunerated for selling services to audit clients. It may be possible in the case of an audit manager having been remunerated for such a sale for safeguards to be put in place to reduce the threat to objectivity to an acceptable level, for example by having a review of the work of the manager in relation to the client. However, it would be more prudent for Kamran & Co not to offer the remuneration scheme at all.

The second suggestion, regarding offering an 'extended audit' service to clients, also creates ethical problems. The issue is that providing an internal audit service to an audit client creates a self-review threat to independence, if the firm uses the internal audit work in the course of a subsequent external audit. The self-review threat arises because of the possibility that the audit team will use the results of the internal audit service, without appropriately evaluating those results or exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm. An acceptable safeguard would be for the internal audit engagement to be performed by a separate team.

IFAC's Code also states that performing a significant part of the client's internal audit activities increases the possibility that firm personnel providing internal audit services will assume a management responsibility. This threat cannot be reduced to an acceptable level, and IFAC's Code requires that audit personnel shall not assume a management responsibility when providing internal audit services to an audit client. Management responsibility may include, for example, performing procedures that are part of the internal control and taking responsibility for designing, implementing and maintaining internal control.

Accordingly, an audit firm may only provide internal audit services to an audit client where:

- The client designates an appropriate and competent resource, preferably within senior management, to be responsible at all times for internal audit activities and to acknowledge responsibility for designing, implementing, and maintaining internal control;
- The client's management or those charged with governance reviews, assesses and approves the scope, risk and frequency of the internal audit services;

- The client's management evaluates the adequacy of the internal audit services and the findings resulting from their performance;
- The client's management evaluates and determines which recommendations resulting from internal audit services to implement and manages the implementation process; and
- The client's management reports to those charged with governance detail the significant findings and recommendations resulting from the internal audit services.

In the case of an audit client that is a public interest entity, an audit firm shall not provide internal audit services that relate to:

- A significant part of the internal controls over financial reporting;
- Financial accounting systems that generate information that is, separately or in the aggregate, significant to the client's accounting records or financial statements on which the firm will express an opinion; or
- Amounts or disclosures that are, separately or in the aggregate, material to the financial statements on which the firm will express an opinion.

Where internal audit services are supplied to an audit client, they should be the subject of a separate engagement letter and billing arrangement, and should also be pre-approved by those charged with governance of the audited entity.

Question:-

a) 'Revenue recognition should always be approached as a high risk area of the audit.'
Required:
Discuss this statement.

b) You are a manager in Tanoli & Co, responsible for the audit of Kashmir Co, a new audit client of your firm, with a financial year ended 31 July 2012. Kashmir Co's draft financial statements recognise total assets of Rs55 million, and profit before tax of Rs15 million. The audit is nearing completion and you are rewiewing the audit files.

Kashmir Co designs and creates high-value items of Furniture. Approximately half of the Furniture is sold in Kashmir Co's own retail outlets. The other half is sold by external vendors under a consignment stock arrangement, the terms of which specify that Kashmir Co retains the ability to change the selling price of

the Furniture, and that the vendor is required to return any unsold Furniture after a period of nine months. When the vendor sells an item of Furniture to a customer, legal title passes from Kashmir Co to the customer.

On delivery of the Furniture to the external vendors, Kashmir Co recognises revenue and derecognises inventory. At 31 July 2012, Furniture at cost price of Rs3 million is held at external vendors. Revenue of Rs4 million has been recognised in respect of this Furniture.

Required:
Comment on the matters that should be considered, and explain the audit evidence you should expect to find in your file review in respect of the consignment stock arrangement.

c) Your firm also performs the audit of Javed Co, a company which installs windows. Javed Co uses sales representatives to make direct sales to customers. The sales representatives earn a small salary, and also earn a sales commission of 20% of the sales they generate.

Javed Co's sales manager has discovered that one of the sales representatives has been operating a fraud, in which he was submitting false claims for sales commission based on non-existent sales. The sales representative started to work at Javed Co in January 2012. The forensic investigation department of your firm has been engaged to quantify the amount of the fraud.

Required:
Recommend the procedures that should be used in the forensic investigation to quantify the amount of the fraud.

Answer:-

a) Revenue recognition
A high risk area of the audit is one where a risk of material misstatement is considered likely to occur. A factor giving rise to a risk of material misstatement is subjectivity, and in many companies revenue recognition is a subjective matter. For example, a company which provides services to customers over a long period of time will need to gauge the proportion of a service that has been provided during the financial year in order to determine the amount of revenue

that may be recognised, possibly on a percentage basis. This determination involves judgement, therefore increasing the risk of material misstatement.

Revenue recognition can also be a complex issue. For example, companies that engage in multiple-element sales transactions need to carefully consider when revenue can be recognised, for instance if selling a tangible item such as a computer, and selling as part of the transaction a two-year warranty, the company needs to separate the sale of the goods and the sale of the services and recognise the revenue on each element of the transaction separately.

Note: Credit will be awarded for any relevant examples of situations where revenue recognition is subjective or complex, for example, when accounting for long-term contracts, linked transactions, sale and leaseback or bill and hold arrangements.

The method of sale and the absence of appropriate internal controls can also mean that revenue has a high risk of material misstatement. For example, when sales are made over a company's website, there is a risk that the website is not fully integrated into the accounting system, creating a risk that sales go unrecorded.

A further issue relevant to revenue recognition is that of fraud. ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements states that the auditor should use a presumption that there are risks of fraud in revenue recognition. Revenue recognition is regarded as an accounting area at risk of fraudulent financial reporting, as it is susceptible to management bias and earnings management techniques. Revenue can be overstated through premature revenue recognition or recording fictitious revenues, or revenue can be understated by improperly shifting revenues to a later period.
There may be issues particular to the company, which mean that deliberate manipulation of revenue is more likely, for example, in a listed company where performance is measured in terms of year-on-year revenue or profit growth.

In a company where a substantial proportion of revenues are generated through cash sales, there is a high risk of unrecorded sales transactions. There is a high risk of theft of cash received from customers which would then lead to unrecorded sales and understated revenue in the financial statements.

However, it is not the case that all companies' revenue recognition is complex, subjective or at particular risk of fraud. Smaller companies with a single source of revenue based on simple transactions do not have a particularly high risk of material misstatement in relation to revenue. ISA 240 requires that where the presumption of a risk of material misstatement due to fraud relating to revenue is not applicable in the circumstances of an audit, the reasons must be fully documented.

b) Matters

The accounting treatment of the revenue and inventory in respect of the consignment stock arrangement with vendors must be carefully considered, as there is a risk that Kashmir Co is recognising revenue too early. According to IAS 18 Revenue, the sale of goods criteria should be applied to a transaction to determine whether the company has the right to recognise revenue. Crucially, revenue may only be recognised when the entity has transferred to the buyer the significant risks and rewards of ownership of the goods and where the entity does not retain managerial involvement or control over the goods.

Kashmir Co's accounting policy is to recognise revenue at the point of delivery of goods to the external vendors. But it seems that Kashmir Co retains managerial involvement, as Kashmir Co retains the ability to change the selling price of the Furniture. Also Kashmir Co retains risk exposure, as any goods unsold after nine months, i.e. goods which are slow moving and potentially obsolete, are returned.

Therefore revenue is being recognised too early, and is overstated by Rs4 million. Profit is overstated by Rs1 million; this is material to profit at 6.7% of profit before tax. Inventory is understated by Rs3 million as it should remain recognised in the statement of financial position, until such time as risk and reward have passed. The inventory held at external vendors is material to the statement of financial position at 5.5% of assets.

If an adjustment is not made to the financial statements, the auditor should consider the implication for the auditor's opinion, which would be qualified due to material misstatement.

There may also be adjustments necessary to the opening balances, which were not audited by Tanoli & Co. Any correction to opening balances should be accounted for retrospectively according to IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Evidence

- Copies of sales contracts with key external vendors and confirmation of the terms of the contract.
- A review of the terms of the contract and conclusion whether the terms indicate that Kashmir Co retains risk exposure and managerial involvement with the goods.
- Results of a direct circularisation to selected external vendors for inventory balances at the year end to ensure the accuracy of the records.
- Enquiries as to the proportion of goods which are usually returned from the external vendors to form an understanding of potential levels of obsolete goods.
- Results of auditor's test counts of inventory at a selection of vendors' premises to ensure the existence of goods held on consignment.
- Client's working papers from the previous year end, such as analysis of receivables and external vendors' inventory reports at 31 July 2011, reviewed to determine the potential adjustment required to opening balances.

c) **Recommended forensic investigation procedures:**

- Obtain all of the claims for sales commission submitted by the sales representative since January 2012 and total the amount of these claims.
- Reconcile the sales per the sales commission claims to the sales ledger control account.
- Agree all sales per the sales commission claims to customer-signed orders and to other supporting documentation confirming that window installation took place, for example, customer-signed agreement of work carried out.
- Obtain external confirmations from customers of the amount they paid for the work carried out.
- Perform analytical procedures to compare the weekly or monthly sales generated by the sales representative committing the fraud to other sales representatives.

Question:-

a) You are the manager responsible for the audit of Dawlance, a listed company, and you are reviewing the working papers of the audit file for the year ended 30 September 2012. The audit senior has left a note for your attention:

'Dawlance outsources its entire payroll, invoicing and credit control functions to Haroon Co. In August 2012, Haroon Co suffered a computer virus attack on its operating system, resulting in the destruction of its accounting records, including those relating to Dawlance. We have therefore been unable to perform the planned audit procedures on payroll, revenue and receivables, all of which are material to the financial statements. Haroon Co has manually reconstructed the relevant figures as far as possible, and has supplied a written statement to confirm that they are as accurate as possible, given the loss of accounting records.'

Required:

i. Comment on the actions that should be taken by the auditor, and the implications for the auditor's report; and
ii. Discuss the quality control procedures that should be carried out by the audit firm prior to the audit report being issued.

b) You are also responsible for the audit of Suzuki, a listed company, and you are completing the review of its interim financial statements for the six months ended 31 October 2012. Suzuki is a car manufacturer, and historically has offered a three-year warranty on cars sold. The financial statements for the year ended 30 April 2012 included a warranty provision of Rs1.5 million and recognised total assets of Rs27.5 million. You are aware that on 1 July 2012, due to cost cutting measures, Suzuki stopped offering warranties on cars sold. The interim financial statements for the six months ended 31 October 2012 do not recognise any warranty provision. Total assets are Rs30 million at 31 October 2012.

Required:
Assess the matters that should be considered in forming a conclusion on Suzuki's interim financial statements, and the implications for the review report.

Answer:-

a)

i. There is a clear lack of audit evidence in respect of payroll, receivables and revenue. The written statement from Haroon Co is not sufficient appropriate evidence on which to reach a conclusion regarding these balances and transactions which are material to the financial statements of Dawlance.

The auditor should consider whether audit procedures alternative to those planned could be used to gather sufficient appropriate evidence. For example, procedures could be performed on the manual reconstruction of accounting records which has been performed by Haroon Co, and receivables could still be contacted to confirm the balances outstanding at the year end. This would rely on the cooperation of Haroon Co, who would have to allow the audit firm access to its accounting records and the reconstruction that has taken place.

The audit firm could request an extension to the agreed deadline for the completion of the audit to perform such additional work. This may be seen as a favourable option to the client, who presumably would want to avoid a modified audit opinion in the event that insufficient audit evidence was obtained.

Given that Haroon Co's accounting systems were affected in August, only one month before the financial year end, it may be possible to obtain sufficient appropriate evidence for the majority of transactions that occurred during the year, and that it is only a small proportion of transactions that cannot be confirmed, which may be immaterial to the financial statements. In this case, an unmodified opinion would be issued.

If further evidence cannot be obtained, the auditor should consider a modification to the auditor's opinion in accordance with ISA 705 Modifications to the Opinion in the Independent Auditor's Report. If the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, then a qualified opinion should be given. In

this opinion, the auditor states that except for the possible effects of the potential misstatements of payroll, receivables and revenue, the financial statements give a true and fair view.

The auditor may conclude that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive, in which case the auditor should disclaim an opinion. In this case, the auditor states that sufficient appropriate evidence has not been obtained to provide a basis for an audit opinion, and accordingly the auditor does not express an opinion on the financial statements.

In any modified audit report, a basis for modification paragraph should describe the matters giving rise to the modification. This should be placed immediately before the opinion paragraph.

It is required that potential modifications are communicated to those charged with governance. The reasons for the modification should be explained, and those charged with governance may be able to provide the auditor with further information and explanations. Given that Dawlance is listed, the communication is likely to be with its audit committee.

ii. Quality control

ISA 220 Quality Control for an Audit of Financial Statements requires that for audits of financial statements of listed entities, an engagement quality control reviewer shall be appointed. The audit engagement partner shall then discuss significant matters arising during the audit engagement with the engagement quality control reviewer.

In the case of Dawlance's audit, clearly the lack of evidence in respect of significant financial statement balances and transactions, and its impact on the auditor's report should be discussed. The engagement quality control reviewer must review the financial statements and the proposed auditor's report, in particular focusing on the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's opinion is appropriate. The audit documentation relating to payroll, receivables and revenue will be carefully reviewed, and the reviewer is

likely to consider whether there are any alternative means of confirming the balances and transactions.

Given the listed status of Dawlance, any modification to the auditor's report will be scrutinised, and the firm must be sure of any decision to modify the report, and the type of modification made. Once the engagement quality control reviewer has considered the necessity of a modification, they should consider whether a qualified or disclaimer of opinion is appropriate. This is an important issue, given that it is a matter of judgement whether the matters would be material or pervasive to the financial statements.

The engagement quality control reviewer should ensure that there is adequate documentation regarding the judgements used in forming the audit opinion, and that all necessary matters have been brought to the attention of those charged with governance.

The auditor's report may not be signed and dated until the completion of the engagement quality control review.

b) Review of interim financial statements

Reviews of interim financial statements are governed by ISRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity. Reviews are based on enquiries and analytical procedures, and having determined that Suzuki has changed its accounting treatment regarding the warranty provision, management must be asked to explain the reason for the change.

Interim financial statements should be prepared under the same financial reporting framework as annual financial statements. Therefore IAS 37 Provisions, Contingent Liabilities and Contingent Assets should be applied.

It would appear correct that a warranty provision is not recognised for cars sold since 1 July 2012, as Suzuki has no obligation relating to those sales. However, cars sold previous to that date are subject to a three-year warranty, so a warranty provision should continue to be recognised for the obligation arising in respect of

those sales. Therefore Suzuki's interim financial statements understate liabilities and overstate profits.

The warranty provision as at 30 April represented 5·5% of total assets, therefore material to the financial statements. If the same warranty provision still needs to be recognised at 31 October, it would represent 5% of total assets, therefore material to the interim financial statements.

ISRE 2410 requires that when a matter comes to the auditor's attention that leads the auditor to question whether a material adjustment should be made to the interim financial information, additional inquiries should be made, or other procedures performed. In this case, the auditor may wish to inspect sales documentation to ensure that warranties are no longer offered on sales after 1 July. The auditor should also review customer correspondence to ensure that warranties on sales prior to 1 July are still in place.

If as a result of performing the necessary procedures, the auditor believes that a material adjustment is needed in the interim financial information, the matter must be communicated to the appropriate level of management, and if management fail to respond appropriately within a reasonable period of time, to those charged with governance. In order to avoid a modification of the report, it is likely that adjustment would be made by management to the interim financial statements.

If the amount remains unadjusted, meaning that in the auditor's opinion the interim financial statements contain a material departure from the applicable financial reporting framework, the report on the review of interim financial information should contain a qualified or adverse conclusion. This is a modification of the report, and the auditor must describe the reason for the modification, which is provided in a paragraph entitled 'Basis for Qualified Conclusion', presented immediately before the qualified conclusion.

The qualified conclusion would be worded as follows: 'Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view...'

Finally, the audit firm should consider whether it is possible to withdraw from the review engagement and resigning from the audit appointment.

Question:-

Qureshi Steels Limited (QSL) is a manufacturer of steel and iron products. During the year the company has incurred a net loss of Rs. 306 million. The following information is also available:

i. At the year end, the company's accumulated losses amounted to Rs. 17 million whereas its net equity was Rs. 283 million.
ii. During the year, QSL has defaulted in repayment of a loan. The management is however quite hopeful that the lender would agree to a rescheduling.
iii. The management believes that the company's profitability has been hampered on account of soaring electricity prices along with a fall in demand for steel which have had a negative impact on the prices of its finished products. Moreover, its production has also suffered on account of the prevailing energy crisis. Consequently, the management has decided to discontinue its operations temporarily.
iv. To counter the impact of high electricity prices, the company intends to convert its plant to run on gas as well.
v. The management has informed you that it would need to install a gas converting unit which would be imported at a cost of Rs. 30 million. However, as the process of installing the gas conversion unit and completing the necessary formalities would take at least a year, therefore the management is negotiating to lease the plant to Nadeem Enterprises for a period of one year.

Required:

a) Evaluate the above situation and state the procedures which you would perform as an auditor in the above situation.
b) Describe the implications of the above issues on the audit report.

Answer:-

a) Although QSL's accumulated losses are only Rs. 17 million i.e. about 5% of the share capital yet the following circumstances indicate that QSL is facing going concern issues:
    - QSL has incurred huge loss during the past year which is almost equal to its share capital.

- QSL has defaulted on its loan repayments.
- The management has certain plans to revive the business however these are subject to major uncertainties as discussed below:
  - The company plans to convert the plant to make it possible to run it on gas. However, it would require significant costs whereas QSL is in financial crisis.
  - It is not certain whether the company's banker would agree on the restructuring of loan.
  - The above conversion would require a year's time and the company may be required to bear the fixed costs for that period.
  - Due to current energy crisis prevailing in the country it seems doubtful that the company would be able to secure a gas connection in the first place and whether sufficient gas would be available to it or not.
  - The company is negotiating to lease its plant temporarily to reduce losses during the period of its planned inactivity. However this plan does not seem very convincing as the prospective lessee would also be subject to the same circumstances.

The auditor would need to evaluate the company's detailed plan by carrying out the following procedures:

i. Review the cash flow projections provided by QSL and assess their reasonableness
ii. Discuss with the management about the uncertainties described above and assess whether the management would be in a position to overcome them.
iii. Consider subsequent events and discuss the impact thereof, with the management, if necessary.
iv. Seek written representation from management regarding its plans for future actions.
v. After performing the above procedures, if there is a doubt about the appropriateness of the going concern assumption, auditor will need to carryout additional audit procedures depending upon the circumstances.

- Besides the going concern issues, the discontinuance of operations of company and reduction in production of steel may result in impairment of plant and machinery, as the company may not be able to recover the

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carrying amount of the plant. The auditor needs to review the value in use of the plant and machinery provided by the client.

b) Implications on the Audit Report:

i. If it is concluded that going concern assumption is appropriate and no material uncertainty exists, the auditor shall express an unmodified opinion.

ii. If it is concluded that going concern assumptions is appropriate but a material uncertainty exists which is adequately disclosed in the financial statements, the auditor shall express:
   - an unqualified opinion
   - include an emphasis of matter paragraph in the auditor's report to:
     - highlight the existence of material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and
     - draw attention to the note in the financial statement which contains the disclosure.

   However, If material uncertainty exists and is not adequately disclosed in the financial statements. The auditor shall express a qualified opinion or adverse opinion as appropriate.

iii. If it is concluded that the going concern assumption is not appropriate, in the preparation of the financial statements the auditor should advise the company to revise the accounts appropriately. In case of disagreement, the auditor shall express an adverse opinion.

iv. If the company revises its financial statements, the auditor shall include an emphasis of matter paragraph referring to the note in the financial statements and explaining that the financial statements are prepared on estimated realizable settlement values of assets and liabilities respectively as the company is no longer a going concern for the reason stated in the aforesaid note.

v. If management is unwilling to make or extend its Assessment, the auditor will issue a qualified opinion or a disclaimer of opinion, as appropriate.

Question:-

You are the manager responsible for the audit of Dulux Paints Limited (DPL). The draft financial statements for the year ended 31 March 2013 show revenue of Rs. 1,250 million (2012: Rs. 1,175 million), profit before taxation of Rs. 100 million and total assets of Rs. 1.2 billion.

The audit incharge has noted the following points for your consideration:

i. In May 2012 a chemical leakage from one of the tanks in the factory caused a fire which damaged the plant and machinery and the premises. DPL has incurred Rs. 3 million in cleanup costs, Rs. 10 million for modernisation of tanks to prevent future leakages and a fine of Rs. 500,000 to a regulatory agency. The fine has been expensed whereas the remaining costs have been capitalised.

ii. While the tanks in the factory were undergoing modernisation, DPL had made arrangements with a nearby factory for storage of its chemicals. At the time of stock check you were informed that it is not possible to segregate DPL's stock from that of the other factory. According to DPL's record, the value of its stock of chemicals as at 31 March 2013 which is lying in the nearby factory is Rs. 200 million. The value of stock of chemicals as at 31 March 2012 was Rs. 120 million.

Required:

Discuss the matters that you would consider and how would you obtain the necessary audit evidence.

Answer:-

i. **Chemical leakage- Evaluation of the situation:**
Matters to be considered

- Fine of Rs. 500,000 has been correctly expensed out but is immaterial.
- The cost of clean-up represents 0.25% of the total assets and 3% of the profit before tax and is therefore not material. However this expense does not improve the future operating capacity of the property and hence it should not be capitalized. If management does not agree to reverse the capitalized amount it will not affect the audit opinion, however, this amount could be included in the aggregate of uncorrected misstatements.
- Rs. 10 million spent on modernizing the storage tanks represents a major overhaul of the asset. It constitute 10% of profit before tax and is therefore

material to the financial statements. The Company has rightly capitalized the said cost.

- The substantial cost of modernization of tanks when included in the present carrying value, may result in carrying value being in excess of the recoverable amount. In this case auditor would need to carryout impairment testing of the storage tanks and if said testing concludes any impairment loss, the auditor would need to check whether such losses have been recognized appropriately.

How audit evidence would be obtained

- The management would be asked as to whether any other fine has been levied by any regulatory agency, due to this leakage; and the matter would be documented.
- Review legal confirmations obtained by you and see whether they contain any information in this regard.
- Physical verification of storage tanks should be carried out.
- Major payments should be vouched.
- Obtain management representation that the matter is now closed and no further proceeding are in progress against the company.
-

ii. Outsourced storage facility- Evaluation of the situation:
Matters to be considered

- Inventory at the end of the reporting period (31 March 2013) represents 16.67% of the total asset value and is therefore a material item in the statement of financial position.
- The inability of the auditor to carry out a stock check may result in a limitation of scope.
- It can be seen that inventory has increased by 67%, although the revenue has increased by 6.4% only. Moreover, there is a decline in the inventory turnover from 9.79 times in 2012 to 6.25 times in 2013. This situation when viewed in the light of auditor's inability to carry out a stock check may indicate the possibility of material misstatement.

How audit evidence would be obtained

- The management should be asked to provide written representation regarding the value of inventory as at 31 March 2013, although it does not provide sufficient evidence regarding its condition or obsolescence.

- Test of control established by the management in respect of quantity, quality and access to the inventory stored at nearby factory.
- Confirmation from the nearby factory needs to be obtained, relating to the quantity of the stock held by them.
- Monthly returns / stock details submitted by neighboring factory should be analysed and significant movements in inventory should be traced to the material consumption reports and purchase invoices.
- The auditor may refer to the inventory aging analysis to determine the possibility of obsolescence of stock.
- Subsequent transfers of chemicals from the neighboring factory to DPL's premises should be reviewed.

Question:-

The following matters relating to different clients are under the consideration of Mr. Naeem, who is the engagement partner:

a) The management of Imran Limited had been illegally dumping its chemical waste in the neighbouring plot of land. When confronted, the chief financial officer, instead of providing an assurance to address the issue, informed the audit senior that the management is least bothered about the minor fines that may be levied by the regulatory agencies.

b) Abdullah was the audit senior assigned to the audit of Mansha (Private) Limited. During the course of the audit, Abdullah had resigned from the firm. While reviewing the audit files Mr. Naeem has noticed that the audit fieldwork was completed in almost half the time than is usually required.

Required:

Evaluate each of the above situations and briefly describe what course of action the engagement partner would be expected to adopt.

Answer:-

a) Dumping of waste
    - The fines levied by the regulatory authority maybe immaterial but the same could have significant implications on ML as any mishap may lead to severe legal action specially in case a mishap occurs.

- The engagement partner should discuss the matter with those charged with Governance and advise them to take necessary steps to avoid future non compliances.
- The engagement partner should consult the legal advisor about the laws and regulations and the possible impact of the non-compliance on the client. If engagement partner is not satisfied with the opinion of ML's legal advisor it should consult with its own lawyer, relating to possible legal consequences.
- If those charged with governance agree to rectify the situation, the auditor need to consider the cost of cleaning up the site and ask the client to make necessary provision. If necessary, the partner may ask ML to obtain opinion from the relevant expert as regards the present condition of the plot and the cost of the measures necessary to clean-up the site in accordance with the requirements of law.
- The partner should consider the possibility of similar non-compliance in other areas.
- In case no action is taken by those charged with governance, the partner must consider:
  - The impact on the audit report.
  - Withdrawing from the engagement now or not accepting the assignment for the next year, as may be appropriate.
- The engagement partner should consider the legal responsibilities to report to the authorities.

b) Engagement performance

- **Quality control issues:**
  - Mr. Naeem should have the audit files reviewed by another chartered accountant who had not been involved in the said engagement.
  - If the working papers reflect anything done improperly or not done in accordance with the auditing standards Mr. Naeem should discuss the matter with the concerned manager.
  - If the audit manager fails to provide a satisfactory reply, it would be indicative of a quality control issue.
  - In such a situation Mr. Naeem would need to take the following steps:
- Address the issues which have remained unattended during the audit.

- Assess the reasons for the manager's failure to detect the situation and take corrective measures which may include all or any of the following:
- Reviewing the firms systems, procedures and policies etc., and taking corrective actions
- Emphasis on due training of staff at all levels.

Question:-

You are the quality control partner of Nishat and Company, Chartered Accountants (NCC) and presently following matters are under your consideration:

a) Your firm has issued an unmodified opinion on the financial statements of Salman Limited (SL) for the year ended 31 December 2012. The tax authorities have recently launched an investigation against SL, alleging that SL has under declared its income for the year ended 31 December 2012. NCC is also acting as the tax advisor of SL.

b) While appreciating the services rendered by your firm, the managing director of a client has informed the engagement partner that an audit trainee has helped him in the purchase of a plot of land. On investigation, the engagement partner was able to establish that the trainee works part-time in an estate agency and receives 0.5% commission on all deals.

c) Javed Limited (JL), an unlisted audit client of your firm has approached your firm to recruit a chartered accountant for the position of finance director in JL. In response to an advertisement published in the newspaper, NCC received various applications which include individuals working at some of your clients and some of your ex-employees.

Required:

Identify and evaluate the threats involved and explain what actions you would take in the above circumstances including the steps required, if any, to reduce the risks to an acceptable level.

Answer:-

a) **Investigation by tax authorities**
   - The tax authorities have launched an investigation against SL on suspicion of under-declaring income. This implies one of the following:

  - The financial statements are materially misstated.
  - The tax return is misstated.
  - The tax official's suspicions are unjustified.
- The quality control partner may engage another chartered accountant to review the financial statements as well as the tax return to investigate the allegations leveled against the client.
- **If Financial Statements are Misstated:**
  - Quality control partner may ask the engagement partner to review the situation and establish whether the financial statements need to be revised.
  - Quality Control Partner may like to know whether the mistake could have been avoided if the Quality control policies of the firm had been followed.
  - If there is a lapse on the part of the firm's employees, appropriate action would be taken and the capacity of the reviewer would also be questioned.
  - If the mistake was such that it could not have been detected using the standard audit procedures of the firm, the firms policies and procedures may be reviewed to ensure that weaknesses if any are properly addressed.
- **If Tax Return are Misstated:**
  - If it is established that tax returns filed by NCC on behalf of the client are materially misstated then NCC should ensure that proper remedial actions (such as revision of tax returns etc) are followed subsequent to the discovery of misstatement.
  - If the above actions are not taken by the client, the auditor should consider the firm's legal responsibilities.
- In the case of error in the financial statement or the tax return, quality control partner would need to assess whether the error was made intentionally by the management.
  - If it is established that the misstatement was made intentionally the auditor would need to review whether it would be appropriate to discontinue its relationship with the client.

b) A close business relationship between a member of assurance team and the management of the client will involve a common financial interest and may create self-interest threat.

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The materiality and significance of the financial interest, needs to be evaluated. If the financial interest is immaterial or relationship is clearly insignificant then the audit trainee may be allowed to work on that client, otherwise only safeguard available is to not to allocate that audit trainee on the client.

If the conduct of the trainee is not in accordance with the firm's policies, appropriate action may be taken.

c) The recruitment of finance director for JL may result in self-interest, familiarity and intimidation threat.

The service to be provided shall not involve making management decision and the decision as to whom to hire should be left to JL.

A threat to Objectivity will be created, because the recruitment team may become biased while dealing with the applications of their former colleagues or if the recruitment team members know the employees of the clients who have applied for the job.

Significance of threat should be evaluated and if the threat is other than clearly insignificant, safeguards should be considered, which may include:

Use of separate engagement teams for the audit and recruitment procedure.

Procedures to prevent access to information (e.g. strict physical separation of audit and recruitment teams, confidential and secure data filing); and

Clear guidelines for members of the engagement team and recruitment teams on issues of objectivity, confidentiality.

The use of confidentiality agreements to be signed by employees and partners of the firm.

Question:-

Zeeshan & Shabir Limited is a distributor of personal care products. Its sales manager had committed a fraud by making sales to fictitious customers. Cheques received from various genuine customers were credited to these fictitious accounts to keep their balances within reasonable limits. The sales manager had the outstanding amounts, appearing against fictitious and genuine customers, written off by convincing the sales director that those customers were unable to pay their remaining balances. A total of 38

invoices amounting to Rs. 7.2 million were issued over a period of seven months. The fraud was detected when the sales manager had left the company's employment.

Required:

Identify the usual controls which may have been lacking in the aforementioned situation.

Answer:-

Controls which may have been lacking in the given situation:

- Control over authorization and approval of customer, as the sales manager was able to make the sale to fictitious customers which means that no proper investigation or processes were followed during approval of said customers.
- Lack of segregation of duties as the write off of receivable balance should have been approved by credit control department/section, instead of or in addition to sales director.
- Controls over write off of debts seem to be lacking. Debts should only be written off when the legal department confirms that they are not recoverable.
  Moreover the legal department should also notify as to what action was taken before deciding that the debts are not recoverable and why a suit was not being filed against the customer. This process does not seem to have been followed.
- Control over accounting of customer's cheques is lacking as the sales manager manages to credit the fictitious customers' accounts with other customers' cheques.
- Controls over preparation, checking and dispatching of debtor's statements to customers is lacking as sales manager manages to manipulate the debtor's accounts for seven months, without any check and balances.

Question:-

You are the job incharge on the audit of Gulfam Petroleum Limited (GPL) for the year ending 30 June 2013. GPL is engaged in the exploration and production of crude oil. The last year's audit file contains the following information:

- In 2005, GPL had entered into an agreement with the Government for exploration and production of oil for fifteen years. The licence for exploration was granted at a fee of Rs. 600 million.
- Under a separate agreement Muslim Petroleum Limited (MPL), a 100% government owned entity, had guaranteed the purchase of all crude oil to be produced by GPL for a period of ten years from the start of commercial production i.e. 2008.
- The plant and equipment was imported in 2006 at a total cost of Rs. 6 billion which includes a decommissioning provision of Rs. 500 million. The cost of the plant was financed by GPL's parent company by way of a long-term foreign currency loan.

During the current year's planning stage, you have observed the following conditions:

i. The problem of circular debts has become severe and as a result GPL as well as MPL have accumulated huge receivables and payables.
ii. An environmental control agency has filed a suit alleging that at the time of abandoning one of its oil wells, GPL has failed to restore the site in accordance with the prescribed standards. The company believes that it has met all its obligations and plans to contest the case strongly.
iii. Due to law and order situation the Government has not been able to provide infrastructure facilities as were agreed in the exploration agreement.
iv. The management had budgeted a profit of Rs. 200 million for the current year but latest estimates suggest that the profit would be somewhere between Rs. 100 to Rs. 120 million.

Required:

Identify and evaluate the audit risks in the above situation and specify the audit procedures that you would perform to address those risks.

Answer:-

Audit risks:

i. **Impairment of assets:**
    - Values of license granted by the Government and the value of plant and machinery for exploration purposes may be impaired due to the following:

- Government has not been able to provide the required infrastructure facilities due to which the exploration work might be affected and GPL might not be able to obtain the expected benefits from the use of plant and machinery.
- Due to the problem of circular debt, MPL may not be able to purchase oil as agreed in the contract.
- Due to circular debt problem there is a possibility that amount of receivable from MPL may be impaired.

Actions to be taken to address the risk:

- Review the exploration contract with the Government to assess whether it contains appropriate clauses to address the situation.
- Ask GPL to carry out the impairment testing of the value of license and check the working thereof.
- Review the agreement with MPL and check what remedy is available to GPL in case MPL fails to purchase oil from GPL.
- Ask GPL to calculate value in use, of the plant and machinery and check the working thereof.
- Discuss with GPL's its relationship with MPL and what measures MPL is taking to resolve its liquidity issue and to ensure that it continues to purchase oil and make regular payments.
- Review the measures that are being taken by the two companies and the Government to resolve the circular debt issue.
- Ensure that incase there is a doubt about the recoverability of the amount, appropriate provision is made in the financial statements.
- If the measures taken above indicate an impairment, ensure appropriate adjustment in the financial statements.

ii. **Going Concern:**

On account of MPL's inability to purchase oil as agreed or to make payments there against GPL's may face going concern issues.

Actions to be taken to address the risk:

- Ask management to make its assessment of the entity's ability to continue as a going concern, if already not performed by the entity.
- Evaluating management's plans for future actions in relation to its going concern assessment.

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- Where the entity has prepared a cash flow forecast, the auditor shall:
  - Evaluate the reliability of the underlying data used in preparation of the forecast.
  - Determining whether there is adequate support for the assumptions used in preparation of the forecast.
- Request written representations from management and where appropriate, those charged with governance, regarding their plans for future action and feasibility of these plans.

iii. **Foreign Exchange Translation Risk:**

The company is exposed to foreign exchange risk as a major part of the cost of plant was financed through foreign currency loan from a parent company and the value of foreign currency loan may fluctuate due to fluctuation in the exchange rates.

Actions to be taken to address the risk:

- The auditor should ensure that year-end balance is accurately reported keeping in view that the year-end balance may differ depending upon whether the client has helped the risk or is maintaining an open position.

iv. Undervaluation of liabilities:

The alleged suit against the company may be indicative of contingent liabilities that may require provision or disclosure in the financial statements and there is a risk that liabilities related to the alleged suits may not be recognized appropriately in the financial statements.

Actions to be taken to address the risk:

- Obtain opinion of the legal advisor.
- Ensure that proper disclosure or adjustment is made in the financial statements, in accordance with IFRS.

v. Over/ Undervaluation of assets:

In case the undervaluation of liabilities (as discussed above) is probable it may be indicative of the fact that the decommissioning provision in other case has also not been estimated correctly and the related plant and machinery may be undervalued or overvalued.

Actions to be taken to address the risk:

- Review the suit filed by the environmental agency and what other actions GPL would need to take to become compliant.
- Review the prescribed standards related to the requirements of restoring the site.
- Ask the management to review the de-commissioning provision accordingly.
- Review the steps taken by management for re-estimating the amount of decommissioning provision.

vi. Overstatement of Results:

The latest estimates show that the company would fail to achieve the budgeted profit.

Therefore, there is a possibility that the management may be inclined to overstate or manipulate the results in order to show better position of the company as compared to the budgeted profits.

Actions to be taken to address the risk:

- Increase the extent of substantive procedures because the above factor would increase the risk of material misstatement.
- Review last minute adjustments and cut-offs more carefully to ensure that the accounts are not misstated.

Question:-

a) Habib Limited has a policy to carry its buildings at revalued amounts. At the balance sheet date i.e. 31 December 2012, the valuer had finalised the valuation reports of only 3 out of a total of 8 properties. According to these reports these properties were assigned a valuation of Rs. 50 million as against the carrying amount of Rs. 62 million.

Required:

Evaluate the above condition and discuss the impact on the audit report in each of the following situations:

i. The impairment of Rs. 12 million is recorded in the financial statements.
ii. The impairment is not recorded.

b) During the year ended 31 December 2012 Chiragh Limited has changed its policy for valuation of investment in a subsidiary from the 'fair value' to 'cost'. Had the company continued with its previous policy for valuation of investment at 'fair value', the subject value would have been reduced by Rs. 50 million.

Required:
Discuss the matters which you should consider in respect of the above situation and the possible impact thereof on the audit report.

Answer:-

a) As per IAS 16, if an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

It is not appropriate to incorporate the revised value of only three properties out of eight as the effect of revaluation of entire class of properties has not been incorporated in the financial statements.

Impact on audit report

i. The auditor would need to mention that the recording of impairment restricted to only 3 properties instead of entire class of assets is not in accordance with the IAS. Moreover, since the valuation of the other properties has not been completed it represents scope limitation and therefore the auditor would be required to give a qualified opinion or a disclaimer, depending upon the materiality of the issue.
ii. The auditor will need to report that the value of three properties at the valuation date is impaired and to report the amount of impairment. Moreover, since the valuation of the other properties has not been completed it represents scope limitation and therefore the auditor would be required to give a qualified opinion or a disclaimer, depending upon the materiality of the issue.

b) Auditor will ask the management for justification for change in accounting policy from fair value to cost method.

The auditor shall mention the exception to the consistent application of accounting policy and a statement that whether they concur with the change in accounting policy or not.

Moreover, the auditor would need to evaluate whether all the accounting treatment/disclosures related to the change have been appropriately recorded in accordance with IAS -8.

If the management is unable to provide reasonable justification for change in accounting policy than the auditor will issue a qualified or adverse opinion, depending upon the materiality and pervasiveness of the matter.

Question:-

You are the audit manager of Rizwan Pharmaceuticals Limited (RPL) for the year ended 30 September 2013. The draft financial statements disclose a profit before tax of Rs. 200 million (2012: Rs. 150 million) and total assets of Rs. 5 billion (2012: Rs. 4.8 billion).

The following matters arose during the course of audit and are under your consideration:

a) RPL has been awarded a 20 year patent right for a new drug with a brand name of Dengcol. The drug has been developed at a cost of Rs. 400 million.
b) As part of the Dengue Control Programme, the Government had provided a conditional grant of Rs. 150 million to RPL for development of Dengcol. Under the terms of the grant, RPL was required to sell 40% of the total production to the Government Hospitals subject to a minimum of 1,000,000 vaccines per annum, for the next five years.

Answer:-

a) **Matters to consider:**
   - Development cost is approximately 8% of total assets and 200% of profit before tax and is therefore material.
   - Whether the development costs incurred on Dengcol meet the capitalization criteria as specified in IAS 38.
   - Carrying value of the patent and possibility of impairment thereof.

   Audit Evidence:
   - Details of development costs to ensure that all the costs meet the criteria specified in IAS 38 for capitalization as intangible asset.

- Assessment and conclusion whether all the costs are related to the development of Dengcol.
- Supports/ vouching related to major payments
- Details of market research performed to ensure that the project is commercially viable.
- Projections prepared by management, assessment of reasonableness of assumptions, recalculation of projections, conclusion whether or not economic benefits to be generated from the use of asset exceed the cost.
- Documents related to registration of patent.
- Written representations from management as to the commercial viability, technical feasibility and adequacy of findings.

b) **Matters to consider:**

- The Government grant represents 75% of profit before tax and is therefore material to the financial statements.
- Accounting treatment of the Government Grant.
- Company's ability to meet the conditions associated with the grant.

Audit Evidence

- Receipt of the government grant of Rs. 150 million, to confirm that the amount has been granted.
- Agreement with the government, to confirm that it is a grant.
- Assessment of whether the company is complying with or in a position to comply with the terms and conditions contained in the agreement.
- Management representation confirming that it is in compliance and would be able to comply with all the conditions attached to the Government Grant.

<u>Question:-</u>

Feroz Limited (FL) is a manufacturer of personal care products. FL intends to diversify its operations by entering into the packaged food business. For this purpose it intends to seek a financing of Rs. 2 billion from Ameen Commercial Bank Limited (ACBL). The company's CFO has prepared a five year cash flow forecast and has presented it to the bank. ACBL has requested your firm to review the forecast in consultation with FL and furnish a report thereon.

On reviewing the cash flow projections, you have noted the following:

i. .

- Cash sales constitute 80% of the total sales of the new business.

- Debtors turnover days related to current business are projected to be reduced from 75 days to 30 days.

ii. In the forecast, 24% of the income is under the head "Income from an associate", which is the management's estimate of the company's share of the associate income. The associated company has confirmed the amounts which are incorporated in the forecast; however no other details are available with FL to support this assumption.

Required:

a) Comment on the above situations and briefly discuss the steps that you would take in the given circumstances.

b) Assuming that your firm decides to modify the report on prospective financial information, draft the basis for modification paragraph and opinion paragraph to be included in the report. ***(You may assume necessary details and choose to base the modification either on para (i) or para (ii) above)***

Answer:-

a) .

I. It is a best estimate assumption and the auditor is required to obtain sufficient appropriate evidence from internal and external sources that best estimate assumptions on which prospective financial information is based are not unreasonable. The following steps may be carried out in this regard:

- Discuss and evaluate how the management plans to reduce the credit period from 75 days to 30 days.
- Consider the market norms and practices, related to credit period prevailing in personal care to assess the reasonableness of assumptions.
- Consider whether food packaging business can expect to achieve 80% cash sales. For this purpose, the general practice prevailing in companies which are in the same line of business may be considered.
- The auditor will need to ask the management to explain basis on which they have made the assumptions specially as regards the assumptions which appear to be un-reasonable in comparison with market practices and norms.

  - If the management is unable to provide the basis on which any of the assumption is based or the basis provided by the management are not appropriate to conclude that the assumptions are reasonable, then the auditor will conclude that the assumption relating to debtors turnover days or cash sales does not provide a reasonable basis for the prospective financial information and will either express an adverse opinion or withdraw from engagement.

II. It is a best estimate assumption and the auditor is required to obtain sufficient appropriate evidence from internal and external sources that best estimate assumptions on which prospective financial information is based are not unreasonable. The following steps may be carried out in this regard:
  - The confirmation provided by the associate company cannot be taken as sufficient appropriate audit evidence in support of company's income from the associated company.
  - The auditor should check the dividend history of the associate to ascertain the reasonableness of the forecasted receipts.
  - The auditor should communicate with management to prepare an investee company income forecast to support the assumptions.
  - If the forecast is prepared, the auditor would need to assess the assumptions on which it is based and to evaluate the overall reasonableness of the forecast.
  - If the forecast is not provided or the auditor is unable to obtain evidence in relation to reasonableness of assumption then it will constitute a scope limitation.
  - If the investee company do not provide forecast then the auditor should either withdraw from the engagement or disclaim the opinion and describe the scope limitation in the report on the prospective financial information.

b) As discussed under the caption "Debtors" in the summary of significant forecast assumptions, the debtor's turnover days are forecasted to be 30 days as compared to present debtors turnover days of 75 days. The debtors turnover days forecasted are not consistent with the prevailing market practices. Further, the company has not committed any resources or taken any steps to reduce the debtors turnover days that provide the basis for reducing debtors' turnover days. The accompanying forecast is not presented fairly in accordance with the International Standard on Assurance Engagements applicable to the examination

of prospective financial information because management assumption, as discussed in the preceding paragraph, do not provide a reasonable basis for management's forecast.

Question:-

You are the manager responsible for the annual audit of Tanveer Limited (TL) for the year ending 31 December 2013. TL is a listed company and is engaged in the business of construction, renting and selling of apartments and office buildings to individuals, businesses and government departments.

Extracts from TL's draft Profit and Loss Account are as follows:

	2013	2012
	(Upton Nov)	
	-----Rs. in million-----	
Revenue	1,520	1,883
Operating expenses	(1,165)	(1,470)
Operating profit	355	413
Financial charges	(190)	(225)
Profit before tax	165	188

During the planning stage, the audit team has presented the following points for your consideration:

i. On 31 January 2014 tenancy agreements of office buildings rented to municipal corporations in 15 small cities in the province of Sindh, are expiring. The concerned departments have informed TL that they would not renew the agreements. These properties are also held as security with the company's bankers.

ii. In August 2013, an apartment block which was completed and sold in 2009 was severely damaged in an earthquake. The residents have filed a claim for damages against TL amounting to Rs. 400 million. The company denies any liability in this regard. However, to maintain its goodwill TL has agreed to compensate the residents by making a payment of Rs. 100 million in four quarterly instalments

and accordingly this amount has been provided in the accounts. The residents have rejected the offer and filed a suit against the company.

iii. During the year, construction equipment costing Rs. 300 million was acquired on lease. The lease rentals were allocated to the contracts on the basis of time utilized. Lease rentals pertaining to idle time were charged to financial expenses.

iv. During the year TL sold a two storey office building to Ali Limited. According to the contract of sale, TL is entitled to construct further offices on the third and fourth floors.

Required:

Identify the audit risks that exist in the above scenarios and describe the manner in which you would address those risks.

Answer:-

Audit Risks:

The audit risks that exists in the given scenarios and the manner in which the auditor would have to deal with them are discussed hereinafter:

i. **Expiry of tenancy agreements**

- If the management of CL does not find any tenant after the expiry of rental agreements with the municipal corporation there is a possibility that value of Investment Property may be impaired.

Manner in which the risk is to be addressed:

- The auditor should ask the management to make impairment testing of the Investment Property and make appropriate provision, if required.
- The auditor would need to assess the assumptions used by the management in determining the fair value and whether the management has considered the effect of expiry of tenancy agreements. If the assumptions applied are unreasonable or does not include the effect of expiry of tenancy agreements, the auditor should discuss and resolve the matter with the management.
- In case the auditor is not satisfied with the assumptions applied by the management or the effect of such assumptions on the valuation he may consider hiring an expert.

ii. **Claim against destruction of apartment block**

- The claim for damages against the company is indicative of contingent liabilities that may require provision or disclosure in the financial statements and there is a risk that liabilities related to the alleged claim may not be recognized appropriately in the financial statements.

Manner in which the risk is to be addressed:

- The petition filed by the residents and the basis of their claim would be reviewed.
- The information provided to the prospective buyers during the marketing campaign would be reviewed to assess whether any claim was made by the company e.g. claim regarding the building being earthquake proof etc.
- Legal opinion would be obtained from the company's lawyers.
- A valuer may be consulted to assess the loss.
- If loss is probable and can be determined with reasonable accuracy management would be asked to make a provision, otherwise a disclosure would be appropriate.

iii. **Construction equipment**

- The accounting treatment of allocation of lease rentals to financial expenses is not appropriate.
- There is a risk of wrong classification of lease that may affect the operating results and financial position of the company.

Manner in which the risk is to be addressed:

- It appears that TL is treating the leasing equipment as an operating lease. The auditor should determine from the leasing agreements whether the lease is a finance lease or operating lease.
- If the auditor considers that treatment of lease is incorrect, the auditor should ask the management to recognize the lease appropriately.
- In case of operating lease, recognizing of lease rentals pertaining to idle time in financial charges is not appropriate. The auditor should ask the management to charge the rentals to the overhead expenditures.
- If the lease is a finance lease, then the auditor should ask the management to recognize it accordingly.

iv. **Construction of three storey building**

- There is a risk that value of right related to use of land for construction of 3rd and 4th floor is not valued and is not recognized appropriately.

Manner in which the risk is to be addressed:

- The auditor would need to assess how this right has been valued in TL's financial statements.
- The auditor would need to review the terms of the sale agreement relating to the first two floors and assess the extent of rights available with the TL relating to the use of building i.e. construction of third and fourth floor. If required a legal opinion may be obtained.
- If appropriate, the auditor may obtain a valuation report to assess the value of the rights available with the client regarding the rights presently attached with the building.
- Based on the above information, the auditor would assess whether the accounting treatment (carrying value of land) is appropriate.

<u>Question:-</u>

Jalal Machinery (Private) Limited (JMPL) is engaged in the manufacture of customized machinery. Recently a fraud has been discovered which was perpetrated by Salahuddin, the purchase manager. Salahuddin was responsible for approving the suppliers after obtaining and evaluating the competitive quotes and placement of orders. Final approval was made by the managing director.

Salahuddin had set up a private limited company Neelum (Private) Limited (NPL) in which his brother and wife are directors. NPL supplies spare parts to JMPL. The fraud was committed with the help of Karamat, a production supervisor and Farhan, the store keeper. The supplies delivered by NPL contained a large proportion of damaged spare parts. However, full payments were made to NPL as Farhan never raised any objections on the quality of goods received. On the other hand, Karamat issued inflated consumption reports to cover significant part of the damaged spare parts.

The fraud was discovered when Farhan went on leave due to illness. A review of inventory sheets indicates that large quantities of spare parts are still lying in inventory.

Required:

Identify the control weaknesses in the above situation which may have enabled the perpetration of fraud.

Answer:-

Control weaknesses in the System:

- There is a lack of segregation of duties as the functions of obtaining and evaluation of bids, approval of supplier and placement of orders are performed by Salahuddin.
- Controls over authorization and approval of supplier, as purchase manager was able to get the approval of NPL, without any detailed background checking.
- There appears no system of stock inspection by an independent person when it is received in the store.
- There appears to be no system of physical verification of stock to identify any damage stock, so that it can be identified on timely basis.
- It appears that there are no benchmarks/standards or other controls over stock consumption i.e. identification of over consumption/under consumption as no concern is raised when production supervisor charges extra costs as to the consumption reports.
- It appears that there are no benchmarks/standards regarding the quantities of inventory that are to be maintained.

<u>Question:-</u>

a) Dynamic (Private) Limited (DPL) is a client of your firm. At the finalization stage of annual audit, it was discovered that a senior member of the assurance team is the co-owner of a property, for the possession of which DPL has filed a legal case. On investigation, the member informed that the said case is pending for the last three years and he did not consider necessary to disclose it at the time of commencement of audit.
Required:
Discuss the matters that should be considered and the course of action which may be followed in the above situation.

b) Murree Limited (ML) and Bhurban Limited (BL) are listed assurance clients of your firm. BL has filed a claim of Rs. 50 million in the court in respect of low quality of goods delivered by ML. Upto last year ML had not acknowledged the claim of BL. However, in the planning phase, you were informed by ML's management that in order to avoid bad reputation in the market and to continue its business relationship with BL, ML intends to settle the dispute by making a payment of Rs. 20 million to BL. The debt of Rs. 50 million is fully provided in the books of BL.
Required:

Being the auditor of both the companies, identify and evaluate the threats for the firm and explain how these can be reduced to an acceptable level.

Answer:-

a) When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest or intimidation threat may be created. The significance of the threat created will depend upon materiality of the litigation. In this regard, the following steps may be undertaken:
   - Disclosing to the audit committee or others charged with governance, the extent and nature of litigation.
   - Involving an additional chartered accountant in the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary.

   If the assurance team member knew about the suit filed and he does not disclose the fact to the firm then, it raises questions related to independence and integrity of the assurance team member, and possible course of action, in additions to the steps taken above may include:
   - If the employee avoided declaring his interest by making an incorrect declaration, appropriate action should be taken against him as per the firm's policies.
   - If no such declaration is required under the firms policies then the QCR policies of the firm need to be reviewed and revised appropriately.
   - Assurance member's argument that he did not consider it necessary to disclose the matter is indicative of deficiency in the training program of the firm and needs improvement.

b) A threat to objectivity or confidentiality may be created when a chartered accountant in practice performs services for clients that are in dispute with each other.

   Significance of threats should be evaluated, if threats are other than clearly insignificant, following safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level:
   - Notifying the client of the firm's business interest or activities that may represent a conflict of interest and obtaining their consent to act in such circumstances; or

- Notifying all known relevant parties that the chartered accountant in practice is acting for two parties in respect of a matter where their respective interests are in conflict, and obtaining their consent to do so; or
- Notifying the client that the chartered accountant in practice does not act exclusively for any one client in the provision of proposed services and obtaining their consent to so act.
- The use of separate engagement teams; and
- Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing); and
- Clear guidelines for members of the engagement team on issues of security and confidentiality.
- The use of confidentiality agreements signed by employees and partners of the firm; and
- Regular review of the application of safeguards by a senior individual not involved with relevant client engagement.
- Where a conflict of interest poses a threat to one or more of the fundamental principles, including objectivity, confidentiality or professional behavior, that cannot be eliminated or reduced to an acceptable level through the application of safeguards, the chartered accountant may resign from the engagement.

Question:-

Kabul (Private) Limited (KPL) has advanced Rs. 100 million to Qandhar Limited (QL), one of its suppliers of raw material. KPL and QL have recently signed an agreement whereby the above advance has been converted into a loan and QL has agreed to pay mark-up on the outstanding balance at prevailing market rates. QL has confirmed the amount of loan and the interest accrued thereon. However, you have acquired some information which suggests that QL is facing financial difficulties.

Required:

Discuss how you would deal with the above situation and possible implications thereof on the audit report.

Answer:-

- The balance confirmation provided by QL, will provide sufficient and appropriate audit evidence with respect to existence and completeness, but not with respect to valuation and disclosures.

- As QL is facing financial difficulties, there is an indication that the recovery of advance is doubtful.
- In order to address the issue the auditor should:
  - Review latest audited financial statements of QL to determine QL's ability to pay back the loan in future.
  - Review the audited financial statements to determine whether QL has defaulted in repayment of any loans and advances etc.
  - Review agreements between KL and QL to check what remedy is available in case of non-payment by QL.
  - Inquire as to the steps taken by QL in order to overcome the financial difficulties.
- Discuss the issue with management and consider their assessment about the recoverability of the amount and assess the reasonability of the assumptions on which such assessment is based.
- If the above procedures, suggest impairment in the value of advance, the auditor should ask the management to make appropriate provision in the financial statements.

Impact on Auditor's Report:

If in the auditor's opinion the recovery of the loan or mark-up accrued thereon is doubtful and the client fails to make appropriate provision in the financial statements, the auditor will issue a qualified opinion or an adverse opinion depending upon materiality and pervasiveness of the matter.

If the management fails to assess the issue objectively or the auditor is unable to obtain relevant and appropriate audit evidence, then it would represent a scope limitation , and the auditor will issue a qualified or disclaimer of opinion depending upon materiality and pervasiveness of the matter.

Question:-

a) ABC and Company, Chartered Accountants, have been requested to give their consent for appointment as the auditor of Sindh Limited (SL), in place of XYZ and Company, Chartered Accountants. The matter of appointment of ABC and Company is to be placed in the annual general meeting of SL.
Required:

i. Explain the responsibility of ABC and Company and the steps that it needs to take before acceptance of the audit.

ii. What would be the retiring auditor's responsibilities with respect to the above and the responsibility of ABC and Company, in case the retiring auditor does not fulfil its responsibility?

b) Assume that in (a) above XYZ and Company had qualified the previous year's audit report because it was unable to physically verify the factory building and to observe physical inventory count, due to law and order situation. However, during the course of current year's audit, ABC and Company was able to observe the physical inventory count and also carry out physical verification of the factory building as the law and order situation has improved.
Required:
Discuss the matters which you would consider in the above situation and the possible impact thereof on the audit report.

Answer:-

a) .

i. New Auditor's (ABC and Company) responsibility before acceptance of audit:

- ABC and Company should consider whether the acceptance of new client would create any threats to compliance with fundamental principles.
- Evaluate significance of threats before accepting the audit engagement. If the threats are other than clearly insignificant, safeguards should be considered and applied as necessary, to eliminate them or reduce them to an acceptable level.
- Communicate with the retiring auditor to establish the facts and circumstances behind the proposed change, however, before communicating it shall seek permission of the client for such communication.
- Comply with relevant legal and other regulations in communicating with retiring auditor.

ii. Retiring Auditor's responsibility:

Retiring auditor is responsible to respond to any communication by the incoming auditor. However, before giving any information about the client, he should seek client's permission.

While communicating with the auditor, the retiring auditor need to meet the legal and ethical requirements related to such communication and disclosure.

The retiring auditor should promptly transfer to the new auditor all books and papers related to SL, which may be held after the appointment has been effected and should also advise SL accordingly.

Incoming Auditor's Course of action if SL and retiring auditor do not fulfill their responsibility:

In case ABC and Company is unable to communicate with the retiring auditor due to any reason, it should try to obtain information about any possible threats by other means such as inquiries from third parties or background investigation of senior management or those charged with governance.

If unable to reduce threats through alternative procedures, it may decline the engagement.

b) The matters that would be considered in the above situation are as follows:
   - Whether auditors are in a position to obtain sufficient appropriate audit evidence with respect to quantities of inventory at the beginning of the year by means of other operating procedures.
   - If auditors are unable to obtain sufficient appropriate audit evidence with respect to quantities of last year through other audit procedures, it will imply that the matter giving rise to modification is still unresolved, and the auditor shall modify the auditor's opinion on the current period's financial statements.

   Impact on the audit report would be as follows:
   - Auditor shall explain in the audit report that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures, although the matter is not relevant to the current period figures.

- Even if the above matters are resolved auditor shall be required to include in the audit report, an other matter paragraph stating that:
  - The financial statements of the prior period were audited by the predecessor auditor, who has issued a qualified opinion due to non-observance of inventory count and date of prior year's audit report.
- The qualification related to non-verification of building of last year is not relevant as the auditor is able to physically verify the building.

Question:-

You are the manager responsible for the audit of Health and Beauty Brands Limited (HBBL) for the year ended 31 March 2014. HBBL has been selling its products through its own retail outlets only. However, during the year under review, HBBL had entered into an agreement for sale of its products at JDS, a chain of departmental stores.

Following information is available in respect of the above:

- According to the agreement, JDS would make payments within 30 days of the sale to customers. Any unsold/expired products would be returned to HBBL.
- The stock sheets provided by JDS to HBBL revealed differences as compared to the balances appearing in the HBBL's inventory system. According to JDS these were due to posting errors in the system of JDS, and have been subsequently corrected. HBBL's management is of the view that such differences are not material as compared to sales made through JDS.
- There is a significant improvement in the operating results of HBBL. The management considers that the agreement with JDS has played a major role in such improvement.
- The confirmation sent to JDS was not received. Alternatively, the audit team had examined partial payment amounting to 65% of the outstanding balance upto 31 May 2014.

Required:

Discuss with reasons, what course of action you would adopt in the above situation and the possible impact thereof on the audit report.

Solution:-

Significant improvements in profits reflects the risk that the revenue and profit in the 2014 financial statements may be significantly overstated.

The following point are needed to be considered in relation to the given situation:

- HBBL's arrangement with JDS is such that JDS facilitated sales to customers but does not purchase the inventory itself and HBBL retains title to the product until it is sold to the final customer.
- HBBL may have knowingly or erroneously, recognize the Sales Revenue on dispatch of goods to JDS.
- Subsequent recovery of 65% upto 31 May 2014, is also not sufficient appropriate audit evidence of receivable balance from JDS, because as per the agreement JDS is required to make the payments within 30 days of sale to customers.
- It is also indicative of the risk that sales/receivable balance is overstated.
- Although, the differences between stock sheets and balances were corrected subsequently, but it is indicative of a risk that during the year there is a possibility of wrong posting in the system of JDS, which consequently will result in overstatement/ understatement of sales and stock in trade

In response to the above we would need to carryout the following procedures:

i. Obtain an understanding of when the sales are recorded in the system.
ii. Enquire the reasons of 65% of subsequent recovery from JDS, and ask for confirmation from JDS.
iii. Review global reconciliation of Sales, Receivable and stock at JDS.
iv. Assess what type of mistakes were made in the stock posting system at JDS and review the reconciliations prepared before making the corrections.

Implications on the Audit Report:

- After performing the above procedures if the auditor finds any error in the recording of sales or receivables, he should ask the client to make appropriate adjustments, failing which the report may be modified i.e. qualified or adverse depending upon the materiality of the amounts involved.
- If we are unable to obtain sufficient appropriate audit evidence, as regards the recording of sales or in relation to receivable from JDS, it will be scope limitation and based on the materiality and pervasiveness of the matter, the auditor may issue a qualified or disclaimer of opinion.

Question:-

You are the quality control partner in a firm of chartered accountants. The following independent situations are under your consideration.

a) Nawaz, a manager in the firm is assigned on deputation for training of the newly hired staff in the accounts department of a brokerage house. The brokerage house is also an audit client of your firm.

b) Your firm has received a proposal from an audit client for implementation of a new IT system which the company has acquired.
c) The client has written a letter of appreciation showing their gratitude for the involvement and guidance provided by an audit manager on various issues regarding application of accounting standards.

Required:

Identify and evaluate the threats involved and explain what actions should be taken in the above circumstances including the steps required, if any, to reduce the risks to an acceptable level.

Solution:-

a) Supervising employees of assurance client in the performance of their normal recurring activities may create self-review or self-interest threats.

   The significance of threats should be evaluated and if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce to an acceptable level. Such safeguards might include:
   - Making arrangement so that personnel providing such services do not participate in the assurance engagement;
   - Involving an additional chartered accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team;

b) The listing regulations clearly stipulate that prohibited services by the auditors include financial information technology system design and implementation, significant to overall financial statements.
   However, if the auditor concludes that it is not significant to overall financial statements and is therefore permissible under the listing regulations, the situation would need to be assessed from the point of view of Code of Ethics, which states that:
   The provision of services involving design and implementation of information systems that are used to generate information forming part of financial statements may create a self review threat.

The self-review threat is likely to be too significant to allow the provision of such services to a financial statement audit client unless appropriate safeguards are put in place ensuring that;

- The audit client acknowledges its responsibility for establishing and monitoring the system of internal controls;
- The audit client designates a competent employee preferably in the senior management cadre, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;
- The audit client evaluates the adequacy and result of the design and implementation of the system; and
- The audit client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.

Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

c) Involvement of audit personnel and guidance to client on accounting principles are an appropriate means to promote the fair presentation of financial statements and the audit process routinely requires dialogue between the firm and management of the audit client and such types of activities are considered to be a normal part of the audit process and do not, generally, create threats to independence

Self-review threat will be involved in above situation, if the auditor assumes management responsibility while providing guidance to the client's management.

Safeguards should be applied to prevent the auditor from assuming management responsibility when providing advice. Safeguards could include:

- Obtaining acknowledgement of responsibility from the client for any actions or decisions made.
- Evaluating the ultimate decision of the client and ensuring that the reasons for their decisions are self-determined
- The risk is further reduced when the firm gives the client the opportunity to make judgments and decisions based on an objective and transparent analysis and presentation of the issues.

Question:-

Abit Businesses Limited is a listed company engaged in the business of manufacturing paints, pharma and chemicals. During the planning stage of an audit, the auditor has found that:

a) The company has advanced a significant amount of Rs. 2.5 billion to a related party, for construction of an office tower. In the notes to the financial statements, it has been stated that transactions with related parties were carried out on arms length basis.
b) The audit committee meetings were not held during the year, because all audit committee members remained out of country. Consequently, the interim financial statements were issued by the company without being reviewed by the audit committee.

Required:

Evaluate and discuss how the auditor should deal with the above situations.

Answer:-

i. The auditor need to ascertain whether transactions with the related party have been appropriately accounted for and disclosed in accordance with the IFRS and Companies Ordinance, 1984.
   Management's assertion that the transactions were conducted on terms equivalent to those prevailing in an arm's length transaction may be materially misstated due to practical difficulties that limit the auditor's ability to obtain audit evidence that all aspects of the audit evidence are equivalent to those of the arm's length transaction.
   - In order to address the above factors, the auditor shall:
     - Inspect the underlying contracts or agreement.
     - Determine the business rationale behind the transaction.
     - Determine whether the terms of the transactions are consistent with management's explanations.
     - Obtain audit evidence that the transactions have been appropriately authorized and approved.
   - The auditor will evaluate management's support for the assertion of arms length transaction, which may involve one or more of the following:
     - Considering the appropriateness of management's process for supporting the assertion.

- Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- Evaluating the reasonableness of any significant assumptions on which the assertion is based.

- In addition to the above, we shall seek representation that management has disclosed all the facts and documents related to the above transaction.

ii. .

- It is a case of non compliance with the Code of Corporate Governance and the auditor would also need to re-assess the risk of material misstatement and consider its impact on other areas of audit.

- Beside the above:

  - If the matter is appropriatly disclosed in the Statement of Compliance with the requirements of Code of Corporate Governance the auditor will highlight this non compliance in the review report drawing attention to the note where the matter has been appropriately disclosed by the management.
  - If the management has not disclosed this matter in the Statement of Compliance or the disclosure is not factually accurate, the auditor will need to qualify his report on the Statement of Compliance with the Code of Corporate Governance.

Question:-

You are the audit manager responsible for audit of consolidated as well as separate accounts of Haier Limited (HL) and its subsidiaries. In the initial meeting, the financial controller has informed you that during the year:

a) the group has changed its policy for valuation of plant and machinery from cost to revalued amount. The revaluation has been carried out by a global firm of professional valuers, who have been advising HL for the last several years.
b) one of HL's subsidiary has incurred substantial losses. Deferred tax has been recognized on these losses. The financial projections prepared by the CFO show that as a result of planned re-structuring, the subsidiary would be able to recoup the losses during the next three years.

Required:

Describe the steps that you would take in each of the above situations.

Answer:-

i. **Change in Accounting Policy**

Steps needs to taken by the auditor:

- Review change in accounting policy for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud.
- Whether the change in accounting policy will result in reliable and more relevant information about entity's financial position, its performance and cashflows.
- Whether the requirements of IAS 16 in relation to change in accounting policy, has been complied with.
- Evaluate the competence, capabilities and objectivity of the professional valuers;
- Obtain an understanding of the work of that valuer; and
- Evaluate the appropriateness of that valuer's work as audit evidence for the relevant assertion
- Consider the need for appointment of an auditor's expert.
- Ensure that all the assets in the entire class of plant and machinery has been revalued.
- Checking appropriateness of disclosures related to the requirements of Companies Ordinance, 1984 and IAS 16.

ii. **Deferred tax asset:**

Steps needs to be taken by the auditor:

- Whether the recognition criteria for deferred tax asset as specified in IFRS has been met.
- Whether the methods estimating the amount of deferred tax are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates are appropriate in the circumstances.
- Determining whether events occurring up to the date of the auditor's report provide evidence regarding the deferred tax asset.
- Review the company's restructuring plan (assumptions) to assess its reasonableness and viability.
- Review the future projections provided by the client and their viability vis a vis restructuring plan.
- Checking appropriateness of disclosures related to the requirements of IAS 12.
- Written representations from the management.

Question:-

a) You are a partner in a firm of chartered accountants, looking after the audit and advisory services department. One of your clients has approached you for services in relation to certification of compliance with a specific control framework, with regard to their production process.
Required:
What are the different types of reports that you can offer to the client, clearly specifying the key characteristics of each form of report.

b) Your manager has identified that the client should prepare a statement of compliance with the said control framework and your firm can only issue a report on that statement.
Required:
Identify the type of assurance engagement to which the manager is referring to and the key characteristics of such engagement.

Answer:-

a) The services may be provided either as an Agreed Upon Procedures Engagement or as an Assurance Engagement other than Audit of Historical Financial Information.

In case of Agreed Upon Procedures, the report will contain the procedures performed and the results of such procedures in the form of factual findings.	In case of assurance engagement, the report may take two different forms i.e. a reasonable assurance report or a limited assurance report.
	In a reasonable assurance report the auditor will provide a positive assurance on the compliance of the entity with the framework.
	In the limited assurance report the auditor will provide negative assurance on the compliance of entity with the framework.

b) The manager is referring to assertion based engagement , in which:
- the evaluation or measurement of the subject matter is performed by the responsible party; and
- the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.

Question:-

ILAP is a large charity based organization, engaged in providing education to needy children, at a token fee of Rs. 100 per child. It receives donations for its activities both in cash and through its bank accounts. The major expenditure relates to payment to teachers and petty cash.

Required:

Briefly describe the key controls which you as an auditor expect to find in respect of receipts and payments.

Answer:-

Overall controls – statement showing donations, fee and income and payments are reviewed by senior management personnel on a monthly basis (i.e. business performance review covering all assertions)

Control over donations

i. Cash
   - For cash received at counters, the cashier counts the cash and prepares a receipt voucher (Completeness, Accuracy, Rights/Obligation, Cut off)
   - For donation boxes – donation boxes are unlocked / opened in the presence of two / three persons and then a cash count is performed following which a receipt voucher is prepared showing details about the date, time, place of box and the total cash collected. (Completeness, Accuracy)
   - Cash count is performed on regular basis by a person independent of the custodian of cash and results are matched with the daily receipt record maintained in the system (Existence)
   - Cash is kept in safe custody and at day end the cash is deposited with bank. (Existence)
   - Surprise cash counts are also conducted by the persons independent of the custodian of cash (Existence)
   - Appropriate segregation of duties exist, i.e. person receiving the cash, maintaining its custody and recording the transactions is not the same

Bank accounts

- Bank reconciliation statements are prepared and reviewed on a regular basis and unadjusted / reconciling items are investigated and recorded on timely basis. (Completeness, Accuracy, Rights / Obligations, Cut off)

Controls over fee income

- The cashier counts the cash and prepares a receipt voucher showing details about the date, time, name of student and the cash collected. (Completeness, Accuracy, Rights / Obligations, Cut off)
- A student wise fee outstanding report is prepared and reviewed on a monthly basis and the schedule of overdue fee is presented to the management for appropriate action as per policy.

Controls over Payments

i. **Teachers**
   - Payroll process is initiated by the payroll department based on the master data maintained by HR department.
   - The attendance record reviewed by the Head of the Department before the processing of payroll.
   - A month-to-month payroll reconciliation is prepared before the distribution of payroll.
   - Changes to master data is made by the HR department only after due authorization.

ii. **Petty cash**
   - Pre-numbered / sequentially controlled petty cash vouchers are maintained.
   - Cash on the basis of IOUs is not disbursed.
   - Surprise cash counts are conducted by the persons independent of the custodian of cash (Existence)
   - Payments are recorded in general ledgers after the details are reviewed by the Finance Manager.

Question:-

Angro Foods Limited (AFL) manufactures a variety of food products. The incharge of the audit team at AFL has requested you to advise on the following issues:

a) During an informal discussion with a company's employee, he came to know that AFL is in litigation with one of its competitors. However, the said case was not included in the list of cases provided by AFL nor was it mentioned by the

legal advisor in his confirmation. On being confronted, the management has informed that they are in the negotiation phase with the competitor and intend to settle the dispute through payment of Rs. 150 million.

b) Stock in trade valuing Rs. 65 million is placed in a warehouse owned by Hameed Limited (HL). According to news reports, FIA has recently initiated an enquiry against HL for evading import duties and taxes. HL has confirmed the quantities of stock at year end.

Required:

Discuss how the auditor should deal with the above situations.

Answer:-

a) .

i. The failure to include all the cases in the confirmation depicts that the legal advisor has not replied appropriately to the general enquiry letter. In this case:
   - The auditor may directly communicate with the legal advisor (after client permission) through a letter of specific enquiry, which shall include the following:
     - Details of litigation for which the auditor needs to obtain information.
     - Management's assessment of the outcome of the identified litigation and its financial implications.
     - A request for confirming the reasonableness of management's assessment and providing further information if the details of case or management's assessment is incorrect.

ii. The auditor's course of action would depend upon the reply to the specific enquiry, and the auditor will proceed in the matter, as follows:

   Legal Advisor confirms the viewpoint of management:
   If the legal advisor confirms that he has not included the said case in his confirmation due to the reasons that the management is in negotiation phase with the competitor and confirms the amount of loss estimated by the management, it will confirm the viewpoint of management.

   Legal Advisor confirms the view point of management but does not agree with the amount provided in the financial statements:

If the legal advisor confirms the viewpoint of management , but disagrees with the management relating to the amount of settlement, then the auditor will ask the management to resolve the matter.

In both the above cases, the auditor will:

- review the legal files of the cases to confirm the lawyer's point of view regarding the outcome of the case
- seek management representation that there are no other undisclosed pending cases.

If the matter cannot be resolved or the management fails to make appropriate adjustments in the financial statements the auditor would consider the impact on the audit report and modify the report accordingly.

Legal Advisor negates the viewpoint of management:

- If the legal advisor does not confirm the information provided by the management or expresses that he does not have any knowledge of the said case, then it will raise concerns with regard to the integrity of management.
- As it is a significant matter therefore the auditor may contact the legal advisor of the company, to address the matter.
- The auditor will also communicate the matter to those charged with governance and asked them to address the situation and determine whether it is possible to perform alternate audit procedures to obtain audit evidence.
- The auditor will determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the persons who made the audit appointment or to regulatory authorities.
- If those charged with governance donot take corrective measures or auditor is unable to obtain audit evidence from alternative procedures, and as the matter relates to the integrity of management, then the auditor will consider options, as withdrawing from engagement or disclaiming the opinion

b) .

i. Discuss the news report with the client to assess the authenticity of your information and what action is the client taking in this regard.

ii. Ask the client for physical verification of stock held by the HL in the presence of an audit team member.
iii. Review the reconciliation between yearend stock and the quantities verified at the auditor's request.
iv. Update your information about the status of FIA'a action so far.
v. In case the severe action against HL is imminent, then consider its impact on the financial statements.
vi. If the expected impact is significant ask the client to resolve the issue (shifting of stock, guarantee from HL etc)
vii. If HL fails to take reasonable action consider its impact on the financial statements and audit report.

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